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UTILITY RATE REGULATION: THE LITTLE LOCOMOTIVE THAT COULDN'T

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"Have we not all seen one little locomotive *pushing* a long string of railroad cars? That's the regulatory process."[1]

"Rate regulation is a misnomer. Public utility "rate cases" are not cases about rates; instead they mainly deal with the amount of revenues that the utility ought to earn.[2] The typical revenue measure provides that the utility is entitled to collect sufficient revenues from its customers to cover proper operating expenses, depreciation expense, taxes and a reasonable return on the net valuation of property (or profit on its investment).[3] Rates are involved only secondarily—if the utility's revenues either were, are or will be[4] approximately the amount derived

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1 Somers, *The 'End Result' Approach to Public Utility Regulation*, 16 BUFF. L. REV. 689, 713 (1967)

2 Grossman, *Reasonable Operating Ratio versus Fair Rate of Return*, 21 J. AIR L. & COM. 15 (1954)

3. P. GARFIELD & W. LOVEJOY, PUBLIC UTILITY ECONOMICS 44 (1964) [hereinafter cited as GARFIELD & LOVEJOY]. Economists seem to prefer to present this notion in the form of a mathematical equation such as RR = E+d+T (V-D) R (*Id.*). [Or R = O+(V-D)r. C. PHILLIPS, THE ECONOMICS OF REGULATION 129 (rev. ed. 1969) (hereinafter cited as PHILLIPS).] *See* the elegant "umbrella" formulation in F. WELCH, CASES AND TEXT ON PUBLIC UTILITY REGULATION 257 (1968 ed.) [hereinafter cited as WELCH].

4 Revenues, expenses, and investment will all vary over time. Therefore, it is necessary in any rate proceeding to select a particular time period for which they will be measured. Although rate cases are generally said to be concerned with rates for the future, commissions will usually use a past

by this formula, its rates are *ipso facto* reasonable and lawful.[5] If, however, the revenues miss the mark by too great a sum, new rates must be effected that appear more likely to bring in the appropriate dollars from ratepayers.[6]

Although there is some controversy in most rate cases about every component of the utility's revenue requirements,[7] the main dispute will invariably relate to the amount of "profit" or "return" the utility is entitled to,[8] calculated as a percentage of the capital dedicated to the utility enterprise.[9] Witnesses will engage in learned arguments about

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period for the various calculations, commonly the last twelve months for which complete data are available. Sometimes the past data will be "adjusted for known changes," which means expenses and investment will be adjusted upward, but revenues will not. This adjustment works to the advantage of the utility, because it lowers the amount of profit the utility is deemed to have earned. *See* PHILLIPS 136; GARFIELD & LOVEJOY 45-46.

5. Wein, *Fair Rate of Return and Incentive*, in PERFORMANCE UNDER REGULATION 39, 40 (H. Trebing ed. 1968). It is of course always possible for a commission to make changes in the price structure that do not affect the total revenue requirements, but merely shift a part of the burden from one class of ratepayers to another. However, in fact, commissions are not interested in price structure problems in a general rate case. *See* Troxel, *Telephone Regulation in Michigan*, in UTILITY REGULATION: NEW DIRECTIONS IN THEORY AND POLICY 141, 176 (W. Shepherd & T. Gies eds. 1966).

6. The effect of rate changes upon revenues cannot be determined without calculating the number of units of each component that will be sold at a new price—a computation that requires assumptions as to nature of the demand for every item. By and large, regulators have ignored this problem and simply assumed that demand is "perfectly inelastic"; *i.e.*, that the same number of units will be sold regardless of price. Bernstein, *The FCC Proceedings—Another View*, 83 PUB. UTIL. FORT. 28, 31 no. 7 (March 27, 1969). The dubious validity of that assumption has been recognized for at least 80 years:

> [I]t is said that it cannot be determined in advance what the effect of the reduction of rates will be. Oftentimes it increases business, and who can say that it will not in the present case so increase the volume of business as to make it remunerative, even more so than at present. But speculations as to the future are not guides for judicial actions; courts determine rights upon existing facts. Of course, there is always a possibility of the future; good crops may increase transportation business, poor crops reduce; high or low rates may likewise affect; but the only fair judicial test is to apply the rates to the business that has been done in the past, and see whether upon that business such rates will be remunerative, or compel the transaction of business at a loss.

Brewer, J., in Chicago & N.W. Ry. v. Dey, 35 Fed. 866, 881 (C.C.S.D. Iowa 1888).

7. *See, e.g.*, the various problems discussed in 1A. PRIEST, PRINCIPLES OF PUBLIC UTILITY REGULATION 47-138 (1969) [hereinafter cited as PRIEST].

8. Lewis, *Emphasis and Misemphasis in Regulatory Policy*, in UTILITY REGULATION: NEW DIRECTIONS IN THEORY AND POLICY 212, 232-33 (W. Shepherd & T. Gies eds. 1966). For example, in the first decision of the Iowa State Commerce Commission, the discussion of "rate base" and "rate of return" takes up 20 of the decision's 30 pages. Re Davenport Water Company, 76 P.U.R. 3d 209 (1968).

9. J. BONBRIGHT, PRINCIPLES OF PUBLIC UTILITY RATES 149-151 (1961) [hereinafter cited as BONBRIGHT].

whether the percentage—known as the "rate of return"—should be determined on the basis of earnings of "comparable investments in other enterprises"[10] or "cost of capital" to the firm itself.[11] In addition, controversy will arise over whether the capital dedicated to the enterprise, or "rate base", should be measured on the basis of the original cost of relevant assets,[12] their "reproduction cost",[13] or their "fair value".[14]

Throughout the history of rate regulation in this country, and increasingly in recent years, critics of the regulatory process have questioned whether this game is worth the candle. They charge that regulating revenues instead of rates removes the utility's incentive to innovate, discourages cost saving and efficient operation, and provides an irresistible attraction for over-investment.[15] These criticisms come

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10. The "comparable earnings" standard is defined as "a return commensurate with returns on other investments attended by corresponding risks." Leventhal, *Vitality of the Comparable Earnings Standard for Regulation of Utilities in a Growth Economy*, 74 YALE L.J. 989, 992 (1965).

11 "Cost of capital" is considered to be "the earnings a utility must hold out to attract the required capital in reasonable amounts and at reasonable times." Kosh, *The Determination of the Fair Rate of Return in Principle and Practice*, 12 PRAC. LAW 9, 37 No. 7 (1966).

12 In its modern form, the actual-cost or net-investment standard may be defined as one which measures the rate base by a summation of the actual legitimate costs of plant and equipment devoted to the public service (including or plus allowances for interest during construction) with appropriate deductions for accrued depreciation and with reasonable allowances for working capital.

BONBRIGHT 173-74.

13. Garfield and Lovejoy draw a distinction between "reproduction cost"—which they define as "the estimated cost of duplicating essentially the identical property at the price level of a specified date or the average price of a stated time period"—and "replacement cost"—which they consider to be "the estimated cost of providing the same service through the most efficient substitute property, at the price level of a stated date or time period." GARFIELD & LOVEJOY 83. The courts have not shown much appreciation for this distinction. *See, e.g.*, C. WILCOX, PUBLIC POLICIES TOWARD BUSINESS 314-18 (3d ed. 1966) [hereinafter cited as WILCOX].

14 "Fair value" is a theological expression and no more susceptible of precise definition than such other theological expression as "the good life". This has frustrated various economists over the years. *See, e.g.*, Henderson, *Railway Valuation and the Courts*, 33 HARV. L. REV. 902, 1031, 1035 (1920) (" 'Fair value' is a myth"); Lewis, *Emphasis and Misemphasis in Regulatory Policy*, in UTILITY REGULATION: NEW DIRECTIONS IN THEORY AND POLICY 212, 235 (W. Shepard & T. Gies eds 1966) (" 'Fair value' is a phoney").

15. The best-known exposition of the adverse efects of rate base regulation is Averch & Johnson, *Behavior of the Firm Under Regulatory Constraint*, 52 AM. ECON. REV. 1053 (1962). The fundamental thesis of their article—that present-day rate regulation affords a regulated firm with a positive incentive to overinvestment, is customarily referred to as the "Averch-Johnson effect". *See, e.g.*, Bailey & Malone, *Resource Allocation and the Regulated Firm*, 1 BELL J. ECON. & MAN. SCI. 129 (1970).

from all directions—utility representatives,[16] regulators,[17] judges,[18] and academicians.[19]

Logically, their arguments have great merit. The public should be primarily interested in the quality of service it receives from the utility and the price it must pay therefor. If quality is high and prices are modest, we should have no concern even if the supplier's investors are reaping rewards beyond their wildest dreams. On the other hand, if service is poor and rates are exorbitant, it is small comfort to learn that the utility's profit picture is also gloomy.

Therefore, it is appropriate to ask why we regulate utility rates in such an illogical and unsatisfactory manner. Most utility veterans will answer that it's done this way because the "damn-lawyers"[20] say it *has* to be done this way. But that "answer" only raises other questions: Why do "damn-lawyers" determine rate-making methods? Where did they get the power? Do they do a decent job of rate-fixing?

This article will attempt to answer these questions. The thesis is that rate base regulation is a vestigial remnant of nineteenth century jurisprudential notions that have since been repudiated by the Supreme Court. In addition, this kind of regulation serves no beneficial purpose in today's society and should be discarded in favor of more meaningful rate appraisal standards.

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16. *E.g.*, Garlinghouse, *Regulation Needs to Change Its Emphasis*, 84 PUB. UTIL. FORT. 17 No. 1 (July 3, 1969) (AT&T); Acheson, *Competition Problems in International Communication*, 13 ANTITRUST BULL. 963, 970 (1968) (Comsat); Rosan, *Comment*, in PERFORMANCE UNDER REGULATION 128 (H. Trebing ed. 1968) (Columbia Gas).

17. *See, e.g.*, concurrences of Commissioners Loevinger and Johnson in Re American Tel. & Tel. Co., 70 P.U.R.3d 129, 227 and 234 (FCC 1967); Bagge, *Broadening the Supply Base of the Gas Industry*, 85 PUB. UTIL. FORT. 23, 27 No. 7 (March 26, 1970) (FPC); Turner, *The Role of Antitrust Policy in the Communications Industry*, 13 ANTITRUST BULL. 873, 878 (1968) (Department of Justice); Re Niagara Mohawk Power Corp., 76 P.U.R.3d 349, 363 (N.Y. Pub. Serv. Comm'n 1968) (Dissent of Larkin).

18. *E.g.*, Driscoll v. Edison Light & Power Co., 307 U.S. 104, 122 (1934) (Frankfurter, J., concurring); Federal Power Comm'n v. Hope Natural Gas, 320 U.S. 591, 645 (1944) (Jackson, J., dissenting).

19. Citations here are legion. Many of the references are collected and discussed in Posner, *Natural Monopoly and Its Regulation*, 21 STAN. L. REV. 548 (1969). *See also* the various papers in UTILITY REGULATION: NEW DIRECTIONS IN THEORY AND POLICY (W. Shepherd & T. Gies ed. 1966); PERFORMANCE UNDER REGULATION (H. Trebing ed. 1968); RATE OF RETURN UNDER REGULATION (H. Trebing & R. Howard eds. 1969).

20. The author does not intend the term "damn-lawyer" as a personal criticism, because he spent a number of years as attorney for a public utility. However, he does concede that the non-lawyers who use the term do not intend it as a compliment.

I. WHY WE REGULATE EARNINGS: THE HISTORICAL EXPLANATIONS

A. Early Regulation: The Munn Doctrine

Modern rate regulation began in this country as a direct outgrowth of agrarian reaction to the country's post-Civil War transition from an agricultural to an industrial society and resentment against the railroad industry.

The rise of industrialism around the time of the Civil War converted the farmer from an individualistic yeoman to a dependent supplier of important but not crucial raw commodities. The Homestead Act of 1862 turned the Great Plains into a vast grain-producing area.[21] But the farmer found his output so increased and specialized that he was no longer able to dispose of it himself at nearby markets accessible by wagon or river barge. Instead, his market lay far to the east in the new industrial centers and across the ocean in Europe.[22] Therefore, the profitability of his products became in large degree a function of conditions beyond his reach or power. In short, he had lost control over his own destiny.

The hostility toward the railroads was due in part to their crucial role in the industrial society's marketing process and in part to a long period of public abuse. The farmer had to deal with the railroad to get his product to its new market and he had to deal on the railroad's terms.[23] The inevitable antagonism this relationship created was further aggravated by the railroad entrepreneurs who had no qualms about charging excessive rates, rebating to favored suppliers, or arbitrarily adjusting rates to reward or penalize certain commodities and shippers.[24]

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21 In the latter half of the nineteenth century, more than 400,000,000 acres of land were occupied by white settlers. This was more than had been occupied in all of the prior history of the country. F. DULLES, THE UNITED STATES SINCE 1865 71 (1969 ed.) [hereinafter cited as DULLES]. The Beards report that in the period 1868 to 1923, 213,860,000 acres were given away to homesteaders, and another 620,000,000 acres were sold to private parties for "making internal improvements and building railways" or turned over to the states. C. BEARD, M. BEARD & W. BEARD, NEW BASIC HISTORY OF THE UNITED STATES 281 (1968) [hereinafter cited as BEARD].

22. W. SWINDLER, COURT AND CONSTITUTION IN THE TWENTIETH CENTURY 62 (1969) [hereinafter cited as SWINDLER].

23. NORTHWOOD INSTITUTE, THE HISTORY OF TRANSPORTATION 73 (19..7).

24. *See, e.g.*, D. PEGRUM, TRANSPORATION: ECONOMICS AND PUBLIC POLICY 287-89 (rev. ed. 1968) [hereinafter cited as PEGRUM]; WILCOX 387-89; Lingo, *The Abiding Influence of Munn v. Illinois*, in LEGAL AND ECONOMIC INFLUENCE OF THE GRANGE 36, 38-39 (1967). For the contrary view that by and large the railroads during this period were run in the public interest, *see* Kirkland, *Economic Growth and Change, 1865-1890*, in INTERPRETING AMERICAN HISTORY II-3, II-12-14 (J. Garraty ed. 1970).

The farmers were joined in their resentment by various local government and private investors who had been victimized by corruption and irresponsible financial speculation and promotion.[25]

These groups found a voice for their grievances during the 1870's in the legislatures of several midwestern states. The Patrons of Husbandry—commonly called the Grange—was organized in 1867 to improve the social and intellectual life of the farmer.[26] Shortly after its founding, it began to work for cheaper transportation and soon attracted a large membership in the grain-producing states.[27] In 1870, a "Producers' Convention" of state farmers persuaded the Illinois Constitutional Convention to insert provisions in the 1870 Constitution requiring the legislature to pass laws regulating railroads and warehouses.[28] In 1871, the Illinois general assembly complied by passing the Railroad and Warehouse Law, setting maximum limits on the rates that could be charged.[29] Similar legislation was enacted shortly thereafter in Wisconsin,[30] Minnesota[31] and Iowa.[32]

This legislation created predictable alarm among capitalist entrepreneurs. Warehouses and railroads were, after all, "private property". In prior eras, when property consisted primarily of tangible realty and personalty, the most important property right was undisturbed use and possession.[33] But as industrialization led to capital combination and absentee ownership, property became, for many people, predominantly intangible. The most important right connected with this "new" property was the right to employ it as profitably as possible.[34] If prices were "too high," they would be reduced by "the laws

25. PHILLIPS 444-46; Sharfman & Peterson, *Railroads,* in 13 ENCY. SOC. SCI. 74, 83-85 (E. Seligman ed. 1934). The financial excesses of the railroad enterpreneurs are graphically described in M. JOSEPHSON, THE ROBBER BARONS Ch. 7 (1934) [hereinafter cited as JOSEPHSON].

26. The background of the movement is set out in E. MARTIN, HISTORY OF THE GRANGE MOVEMENT (1873) [hereinafter cited as MARTIN].

27. The organization apparently reached its peak in 1874 with a membership of around 750,000 persons. H. PARKER, THE UNITED STATES OF AMERICA: A HISTORY (3d ed. 1968) [hereinafter cited as PARKER].

28. ILL. CONST. art. XIII (1870).

29. Acts of April 15, 25, 1871. Ill. Laws 1871-73, pp. 640, 762.

30. Act of March 11, 1874. Wis. Laws 1874, c. 273.

31. Act of March 4, 1871. Minn. Laws 1871, c. 22, p. 56.

32. Railroad Tariff Law of March 23, 1874. Iowa Laws 1874, c. 68, p. 61.

33. For example, in the Slaughter House Cases, 83 U.S. (16 Wall.) 36 (1872), the Court held that the right to engage in the slaughter house business was not "property." *Id.* at 81.

34. B. TWISS, LAWYERS AND THE CONSTITUTION 257 (1942) [hereinafter cited as TWISS]. The shift in views is described in J. COMMONS, LEGAL FOUNDATIONS OF CAPITALISM 11-46 (1946).

of trade" or "competition."[35] There appeared to be something distinctly un-American in the notion that whenever customers could muster enough votes to control the state legislature, they could decide for themselves the prices they would pay to use the railroaders' property.[36] If this power was granted with respect to railroads and warehouses today, what industry would be safe tomorrow?

When they lost the fight in the state legislatures, the warehousemen and railroad entrepreneurs attacked these so-called "Granger laws"[37] in the courts. Cases testing all four laws were instituted in various courts and soon made their way to the Supreme Court of the United States.[38] The Supreme Court heard argument on the various cases in October and November of 1875 and January of 1876,[39] but did not decide the cases until March 1, 1877.[40] The principal decision of the Court was presented by Chief Justice Waite in an Illinois warehousemen's case, *Munn v. Illinois*.[41]

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35 Statement of Orville H. Browning at Illinois Constitutional Convention of 1869-70, quoted in Fairman, *The So-Called Grange Cases*, 5 STAN. L. REV. 586, 594 (1953).

36 *See, e.g.*, statement of John F. Dillon, quoted in C. JACOBS, LAW WRITERS AND THE COURTS 160 (1954) [hereinafter cited as JACOBS]; *see also* the brief of Edwin W. Stoughton for the defendant railroad in Peik v. Chicago & N.W.R.R., 94 U.S. 164 (1877), quoted in Fairman, *The So-Called Grange Cases*, 5 STAN. L. REV. 587, 641 (1953):

> It is quite true that the theory of the statute is distinct from the doctrine of the Communists. The latter divides property ratably between the plundered and the plunders, while the former takes all for the Grangers.

37. Fairman maintains that it is factually incorrect to attribute the passage of these laws to the Grange, because the primary legislation was passed before the Grange movement had achieved any momentum. Fairman, *The So-Called Grange Cases*, 5 STAN. L. REV. 587, 599 (1953).

38. The Illinois law was involved in Munn v. Illinois, 94 U.S. 113 (1877); the Iowa law in Chicago, B. & Q. R.R. v. Cutts, 94 U.S. 155 (1877); the Minnesota law in Winona & St. P. R.R. v. Blake, 94 U.S. 180 (1877); and the Wisconsin law in Peik v. Chicago & N. W. R.R. Co., 94 U.S. 164 (1877); Chicago, M. & W. P. R.R. v. Ackley, 94 U.S. 179 (1877); and Stone v. Wisconsin, 94 U S 181 (1877).

39 *Winona* and the Wisconsin cases were heard in October and November, 1875. The Iowa case and *Munn* were not heard until January, 1876.

40 In spite of the long time lag between the dates of argument and decision, Justice Strong complained that he had had no time to prepare a dissenting opinion, and Justice Field did not file his dissenting opinion until a later date. C. SWISHER, STEPHEN J. FIELD: CRAFTSMAN OF THE LAW 375-76 (1930) [hereinafter cited as SWISHER].

41 94 U.S. 113 (1877). Swisher speculates that the Chief Justice selected *Munn* as the principal case, even though it was the last one argued, because "grain elevators seemed to him to provide a better analogy with which to tie into the relevant phase of English common law than did the railroads." SWISHER 372. The present author finds that speculation questionable at best, because railroads are clearly "common carriers"—one of the classes specifically referred to by Waite. He feels the likelier explanation the fact, which Swisher notes, that the grain warehouse case was the least controversial one pending before the Court.

Munn and his partner Scott had been prosecuted criminally for carrying on a grain warehouse business in the City of Chicago without obtaining the license required by the Railroad and Warehouse Law of 1871. Their principal defense was that the statute was repugnant to the Federal Constitution because it attempted to fix the maximum price a person could receive from those who chose to deal with him. Such a statute, they argued, deprived the warehouse owners of their property without due process of law.

Chief Justice Waite rejected that argument. He noted first that maximum prices had been fixed "in England from time immemorial and in this country from its first colonization" for "ferries, common carriers, hackmen, bakers, millers, wharfingers, and innkeepers."[42] These prices could be fixed because property became "clothed with a public interest when used in a manner to make it of public consequence and affect the community at large."[43] So far as grain warehouses were concerned, the Chief Justice noted that the "vast production of 'seven or eight great states of the West' " must pass through the warehouses in Chicago to reach " 'four or five states on the seashore' " and that all of the warehouses adapted to the grain business were controlled by only nine business firms.[44] In view of these facts, it was appropriate for the people of Illinois "to suppose that remedies such as usually employed to prevent abuses by virtual monopolies might not be inappropriate here."[45] Moreover, for such a business, the question of what is reasonable compensation is for the legislature, and not for the courts:

> We know that this is a power which may be abused; but that is no argument against its existence. For protection against abuses by Legislatures the people must resort to the polls, not to the courts.[46]

The Chief Justice was then able to dispose of the railroad cases briefly; their status as carriers for hire obviously qualified them as "engaged in a public employment affecting the public interest" regulable under *Munn*.[47] The main distinction between the cases was that the railroads were corporations and they argued that their corporate charters were contracts which the state could not constitutionally impair by

42. Munn v. Illinois, 94 U.S. 113, 126-30 (1877).
43. *Id.* at 126.
44. *Id.* at 130-32.
45. *Id.* at 132.
46. *Id.* at 134.
47. Chicago, B. & Q. R.R. v. Cutts, 94 U.S. 155 (1877).

subsequently limiting the rates they might charge. The Chief Justice rejected this argument on the ground that the charters of corporations are subject to the controls of all relevant laws; if a railroad wanted protection against future legislative interference, it had to make that protection an express part of the charter itself.[48]

Justice Field prepared a vigorous dissent to the *Munn* decision, in which he was joined by Justice Strong. He distinguished the examples of price regulation cited by Waite on the ground that they all involved

> . . . some special privilege granted by the state or municipality; and no one, I suppose, has ever contended that the State had not a right to prescribe the conditions upon which such privilege should be enjoyed.[49]

As to all other businesses, Field argued that the power of the State was constitutionally limited to the taking of property for public uses upon the payment of just compensation, and to regulations under the police power "having for their object the peace, good order, safety and health of the community . . . ; but in establishing those regulations it is evident that compensation to the owner for the use of his property, or for his services in union with it, is not a matter of any importance."[50] He emphatically rejected the proposition that grain warehousing was in a special caregory "affecting the public interest" with the comment that

> . . . there is hardly an enterprise or business engaging the attention and labor of any considerable portion of the community, in which the public has not an interest in the sense in which that term is used by the court in its opinion.[51]

Field and Strong also filed a brief dissenting opinion in the railroad cases. They stated that the questions raised with respect to impairment of the obligations of the corporate charters were "of the gravest importance,"[52] but that in view of *Munn*, it would be "a waste of words" to discuss them.[53]

The *Munn* doctrine recognized an extensive power in the state legislatures to regulate the prices charged by private parties for their goods and services. The state had only to determine that the circumstances with respect to a particular business warranted the

48. *Id.* at 162.
49 Munn v. Illinois, 94 U.S. 113, 148-49 (1877).
50 *Id.* at 146.
51 *Id.* at 141.
52 Chicago, B. & Q. R.R. Co. v. Cutts, 94 U.S. 155 (1877).
53 *Id.* at 186.

imposition of some form of price control and, "if a state of facts could exist that would justify such legislation," the courts would assume that it did exist.[54] Under those circumstances, *Munn* seemed to say, the property owner was at the mercy of the legislature.[55] This was consistent with the Court's general attitude at the time—except in the general area of race relations, there was no limitation on the police power of the states.[56]

B. Retreat: From Munn to Smyth

Interestingly enough, Chief Justice Waite led the retreat from the notion of state legislative supremacy set out in *Munn*. In 1882, he wrote the majority opinion in *Spring Valley Water Works v. Schottler*,[57] upholding the power of California to change by constitutional amendment a provision in the charter of a water company that its rates would be set by a bipartisan commission to a requirement that rates be set by municipal authority. In the course of his opinion, the Chief Justice noted:

> What may be done if the municipal authorities do not exercise an honest judgment, or if they fix upon a price which is manifestly unreasonable, need not now be considered, for that proposition is not presented by this record.[58]

He expanded this theme in 1886, in *Stone v. Farmers' Loan & Trust Co.*[59] *Stone* resembled *Spring Valley* in that it concerned the power of a state to subject a company's rates to regulation by a state commission, in spite of charter language authorizing the company's directors to fix rates and charges. Although he upheld the state's action, Waite also set definite limits on its available regulatory powers:

> [I]t is not to be inferred that this power of limitation or regulation is itself without limit. This power to regulate is not a power to destroy, and limitation is not the equivalent of confiscation. Under pretense of

54. Munn v. Illinois, 94 U.S. 113, 132 (1877). The scope of judicial review contemplated was only "to ascertain whether the field which the legislature in this instance had assumed to occupy was on which a legislature might ever enter legitimately." Corwin, *The Supreme Court and the Fourteenth Amendment*, 7 MICH .L. REV. 642, 648 (1909).

55. *See* 1 C. TIEDEMAN, STATE AND FEDERAL CONTROL OF PERSONS AND PROPERTY 308-09 (1900) [hereinafter cited as TIEDEMAN].

56. Corwin, *The Supreme Court nd the Fourteenth Amendment*, 7 MICH. L. REV. 642, 649-50 (1909).

57. 110 U.S. 347 (1884).

58. *Id.* at 354.

59. 116 U.S. 307 (1886).

> 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 a taking of private property for public use without just compensation, or without due process of law. What would have this effect we need not now say . . . .[60]

The seeds which Waite had planted in *Spring Valley* and *Stone* reached full flower in the ten years following his death in 1888 and his succession in the Chief Justiceship by Melville W. Fuller.[61] Those ten years were the period of *Knight*,[62] *Pollock*,[63] *Monongahela*[64] and *Allgeyer*[65]—a period in which the court consistently supported the "doctrine that private commercial activity should be confronted with a minimum of public interference."[66]

The Court's threat to subject rate-making to judicial scrutiny became a reality in *Chicago, Milwaukee & St. Paul Railway Co. v. Minnesota*.[67] Minnesota had set up a railway commission, with power to determine what rates were "equal and reasonable". If a railroad refused to comply with a rate reduction order, the commission was empowered to obtain a writ of mandamus from state court. The commission sought such a writ against the Chicago Railway, which tried to defend by showing that the reduced rates were not "equal and reasonable". The state court refused to hear the defense because it construed the state statute to make rate decisions of the commission final and nonreviewable. The Supreme Court reversed, holding that such a statute was unconstitutional:

> The question of the reasonableness of a rate of charge for transportation by a railroad company involving as it does the element of reasonableness, both as regards the company and as regards the public, is eminently a question for judicial investigation, requiring due process of law for its determination. If the company is deprived of the power of charging reasonable rates for the use of its property, and such deprivation takes

60 *Id* at 331. *See also* Dow v. Beidelman, 125 U.S. 680, 690-91 (1888).

61 Swindler says "the history of the modern Constitution may . . . be dated roughly from the appointment of Melville W. Fuller to the Chief Justiceship in 1888." SWINDLER *vii*.

62 United States v. E.C. Knight & Co., 156 U.S. 1 (1895) (Sherman Antitrust Act does not apply to the manufacture of goods).

63. Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, 607 and 158 U.S. 601 (1895) (federal income tax is unconstitutional).

64 Monongahela Navigation Co. v. United States, 148 U.S. 312 (1893) ("Just compensation" is a judicial question).

65 Allgeyer v. Louisiana, 165 U.S. 578 (1897) ("Freedom of contract" is protected by the Fourteenth Amendment).

66 SWINDLER 35.

67. 134 U.S. 418 (1890).

> place in the absence of an investigation by judicial machinery, it is deprived of the lawful use of its property, and thus, in substance and effect, of the property itself, without due process of law and in violation of the Constitution of the United States; and insofar as it is thus deprived, while other persons are permitted to receive reasonable profits upon their invested capital, the company is deprived of the equal protection of the laws.[68]

The vote was split and evidently caused the Court considerable concern. Justice Miller concurred solely on the ground that he felt the railroad had a right to be heard in defense of the application for mandamus;[69] Justices Bradley, Gray and Lamar dissented because they thought the court was bound to the contrary by *Munn*.[70] Moreover, less than two years later, Justice Blatchford, the author of the *Chicago, Milwaukee* decision, gave that decision the narrowest possible construction, holding that it applied only "to charges fixed by a commission appointed under an act of the legislature, under a Constitution of the State which provided that all corporations, being common carriers, should be bound to carry on 'equal and reasonable terms' and under a statute which provided that all charges made by a common carrier for the transportation of passengers or property should be 'equal and reasonable.' "[71]

However, by 1894, the Supreme Court gave up all pretense of even a limited viability for the doctrine of legislative rate-making supremacy promulgated in *Munn*. Although Justice Field was still a member of the Court, the leadership role passed to his nephew, Mr. Justice Brewer, who shared Field's dedication to "the economic and personal liberty of the persevering free individual."[72] As a circuit judge before his appointment to the Supreme Court, Brewer had held that the courts had a duty to ensure that legislatively-established maximum rates were at least sufficient to ensure compensation to the owners of the business involved.[73] After his appointment to the Supreme Court, he consistently argued for the imposition of two limitations on the "radically unsound"[74] doctrine of *Munn*: (1) that rate regulation can only be

68. *Id.* at 458.
69. *Id.* at 460-61.
70. *Id.* at 461-66.
71. Budd v. New York, 143 U.S. 517, 546 (1892).
72. Gamer, *Justice Brewer and Substantive Due Process*, 18 VAND. L. REV. 615, 630 (1965).
73. Chicago & N.W. R.R. v. Dey, 35 Fed. 866 (C.C.S.D. Iowa 1888).
74. Budd v. New York, 143 U.S. 517, 548 (1892) (dissenting opinion).

imposed on property "devoted to a public use",[75] and (2) as to those businesses where rates could be legislatively regulated (primarily railroads), the courts must ensure that the rates prescribed by the state were "reasonable".[76] He was never able to muster a majority of his colleagues for his first proposition,[77] but the Court adopted his second argument in 1894 in *Reagan v. Farmers' Loan and Trust Company*.[78] Brewer's decision in *Reagan* destroyed the distinction Blatchford had tried to make between rates set by legislatures and those set by commissions, and held that in both instances courts had a "power and duty to inquire whether a body of rates prescribed by a legislature or a commission is unjust or unreasonable, and such as to work a practical destruction to rights of property, and if found so to be, to restrain its operation."[79]

Thus, by 1895, less than twenty years after *Munn*, the Court had put itself squarely into the rate regulation business. In view of its prior decisions, it regarded the following fundamental propositions as "settled":

> 1. A railroad corporation is a person within the meaning of the Fourteenth Amendment.
> 2. A state enactment, or regulations made under the authority of a state enactment, establishing rates for 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.
> 3. While rates for the transportation of persons and property within the limits of a State are primarily for its determination, the question whether

75. *Id.* at 552.

76 Chicago & G.T. Ry. v. Wellman, 143 U.S. 339, 344 (1892).

77 The most dramatic example of the rejection by the other Justices of Brewer's distinctions between regulable and nonregulable industries is found in Cotting v. Kansas City Stock Yards Co., 183 U S. 79 (1901). That case concerned the constitutionality of a Kansas statute setting maximum prices that could be charged by stockyards that handled more than 100 head of cattle per day. Brewer, writing the "Opinion of the Court", held the statute to be unconstitutional because: (1) the distinction between stockyards handling more than 100 head of cattle and those handling fewer was unjustifiable, and (2) the state had no power to regulate the profits of a stockyard company where no "public service is distinctly intended and rendered." *Seven* of his colleagues (all but Chief Justice Fuller) concurred, but solely on the ground that the statute applied only to the defendant and therefore denied it equal protection. They expressly refused to indicate any opinion on Brewer's arguments.

78 154 U.S. 362 (1894).

79 *Id.* at 397.

> they are so unreasonably low as to deprive the carrier of its property without such compensation as the Constitution secures . . . 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.[80]

One very important fact with respect to these propositions should be emphasized. The Court was not concerned about finding criteria for determining when a given rate or set of rates was "reasonable" with respect to anyone other than the regulated carrier. It assumed that the legislative body setting the rates was consumer oriented, and therefore would always establish a rate *low enough* to please the customers. The Court's only function was to protect the utility owner whose voice was not heeded by the legislature and to ensure that the rates were not too low from his standpoint.[81]

Perhaps protection of this type was necessary in the context in which the Court was acting. The railroads serving the midwestern states were primarily interstate in character and controlled by Eastern interests. Although they attempted—by savory and unsavory means[82]—to influence state legislatures, they probably could no longer thwart the pressures put on the legislators of a state such as Nebraska by local residents who were absolutely dependent on the railroads for their economic survival. However, the Court recognized the crucial importance of the railroads to the economy of the time[83] and that

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80. Smyth v. Ames, 169 U.S. 466, 526 (1897).

81. Dakin, *The Changing Nature of Utility Rate Regulation*, 36 TUL. L. REV. 401, 407 (1962). *See also* BEARD 300-01; E. FREUND, THE POLICE POWER 60 (1907); 2 TIEDEMAN 981; JACOBS 1; Corwin, *The Supreme Court and the Fourteenth Amendment*, 7 MICH. L. REV. 642, 658-72 (1909).

82. Some of the methods used are described in JOSEPHENSON at 130-31, 142-45, 164; SWISHER 314-65; MARTIN 165-73 (1873). The manner in which the railroads magnates operated was described in 1871 by Charles Francis Adams:

> These modern potentates have declared war, negotiated peace, reduced courts, legislatures, and sovereign states to an unqualified obedience to their will, disturbed trade, agitated the economy, impaired taxes, and, boldly setting both law and public opinion at defiance, have freely exercised many other attributes of sovereignty . . . . The strength implied in all this they wielded in practical independence of the control of both governments and individuals; much as petty German despots might have governed their principalities a century or two ago.

Quoted in DULLES 54.

83. Railroads were vital to the American economy of 1865-1900 in several respects. First of all, the railroad was "the major instrument in subduing the continent." Sharfman & Peterson, *Railroads*, in 13 ENCYC. SOC. SCI. 74, 75 (E. Seligman ed. 1934). Second, it was the dominant form of transportation until the 1920's. *Id.* at 78; E. KIRKLAND, A HISTORY OF AMERICAN ECONOMIC LIFE 287-292 (4th ed. 1969) [hereinafter cited as KIRKLAND]. Third, reliance on the railroads for basic transportation "freed the country from the severe geographic and weather limitations of water

construction and maintenance of those railroads were primarily financed by private capital. Unless the assets devoted to railroading could afford their owners at least a "fair return", private capital would be likely to forsake the industry in favor of other, more lucrative opportunities. The result at that time would most likely have been a drastic decline in railroad development, which, in turn, would have seriously hampered the growth of the economy. To prevent this, the Court felt it had to set an outer limit beyond which the legislature could not go in attempting to satisfy local citizens.

To complete its work the Court had only to determine those criteria which would indicate when state-set rates were in fact "unreasonably low". After several decisions rejecting arguments that it should rely solely on the books and records of the utility itself,[84] the Court spelled out the appropriate criteria in the famous case of *Smyth v. Ames*.[85]

The most interesting decision in the *Smyth* litigation was that handed down in the trial court by Justice Brewer sitting as Circuit Justice.[86] The case concerned an 1893 act of the Nebraska legislature, which prescribed maximum rates for the transportation of freight within the state. The lawsuit was filed before the effective date of the act, to restrain the state officials from putting the act into force.[87] The nub of the railroads' argument was that the act was unconstitutional because the specified rates, if applied to their most recent full business years, would not provide sufficient revenue to cover the costs of the service. Both Justice

routes, and . . . made possible the rise of modern metropolis. . . ." PEGRUM 52. Perhaps more important, railroading was the country's first "big business" and thus introduced modern methods of finance, corporate management, labor relations, competition—and of course government regulation THE RAILROADS: THE NATION'S FIRST BIG BUSINESS (A. Chandler ed. 1965). For the somewhat contrary but thoughtful and intriguing argument that the economy would have developed in roughly the same manner even if there had been no railroad industry, *see* R. FOGEL, RAILROADS AND AMERICAN ECONOMIC GROWTH (1964).

84 *E g.*, Chicago & T. R.R. v. Wellman, 143 U.S. 339 (1892); St. Louis & S. F. R.R. v. Gill, 156 U S. 649 (1895); Covington v. Sandford, 164 U.S. 578 (1896).

85. 169 U.S. 466 (1897).

86. Ames v. Union Pac. R.R., 64 Fed. 165 (D. Neb. 1894). Circuit courts were created by the Judiciary Act of 1789, with original jurisdiction in all diversity cases, most criminal cases, and large cases to which the United States was a party, plus limited appellate jurisdiction over the district courts Until 1869, there were no circuit court judges, and the circuit courts were held by district judges and justices of the Supreme Court. The justices continued to sit on circuit courts until those courts were abolished in 1911. C. WRIGHT, LAW OF THE FEDERAL COURTS 3-5 (2d ed. 1970).

87 The *Ames* litigation was brought by stockholders of a number of railroads as plaintiffs, with the railroads themselves and Nebraska state officers as nominal parties defendant. However, the railroads obviously were plaintiffs in fact.

Brewer and the Supreme Court held that this showing was sufficient to warrant barring the state from enforcing its legislation.[88]

In his decision, Brewer first attempted to explain the appropriate function of rate regulation. He noted that the transportation of persons and property was similar to the transportation of letters, and could therefore have been a legitimate function of government. However, in the history of the United States, only the transportation of letters was undertaken by the government, and the transportation of persons and property had been left to private persons. The government had adopted a policy in its own mail transportation of "equal service to all, and uniform rates" without regard to the resulting effects on revenues or profits. On the other hand, with respect to the carriage of persons and property, the government permitted and even encouraged private persons to make substantial investments, "with a view to private gain." Consequently, Justice Brewer explained, the approach to prices and service in that area was quite different:

> Now, in the carrying on of any private enterprise, increase of business with increase of profits is a stimulating thought, and for this every variety of action is taken. Advertisement, solicitation, inducement, favors, are all freely resorted to, but with the single purpose of larger business and greater gain.[89]

With rate regulation, Brewer felt, transportation of persons and property entered an "experimental or transitional stage." He recognized a "growing conviction" that the government should take the railroads over and run them like the post office. However, there was no absolute certainty that the post office philosophy of "equal service to all, and uniform rates" would lead to socially desirable consequences in the railroad field, or that the people would be willing to undertake the financial burden involved in taking over all the railroad properties. Therefore, the public was seeking to accomplish the result of rate uniformity by "compulsory legislation," while leaving the property in private hands.[90]

What did the Constitution say with respect to such legislation? The key, according to Brewer, was the fact that the government was seeking to accomplish the same goals it would realize with condemnation.

88. Justice Brewer had previously recognized the infirmities inherent in a presentation of this nature. *See* note 6 *supra* and accompanying text.

89. Ames v. Union Pac. R.R., 64 Fed. 165, 173-76 (D. Neb. 1894).

90. *Id.* at 175-76.

Therefore, the same constitutional protections should be applicable:

> . . . [I]f the public was seeking to take title to the railroad by condemnation, the present value of the property, and not the cost, is that which [it] would have to pay. In like manner, it may be argued that, when the legislature assumes the right to reduce, the rates so reduced cannot be adjudged unreasonable if, under them, there is earned by the railroad company a fair interest on the actual value of the property.[91]

In fact, Brewer argued, it may be that the earnings allowed to the owner of a regulated railroad should be even higher than the eminent domain standard of "actual value":

> Is there not an element of equity which puts the reduction of rates in a different attitude from the absolute taking of the property by virtue of eminent domain? In the latter case, while only the value is paid, yet that value is actually paid, and the owners may reinvest, and take the chances of gain elsewhere, whereas, if the property is not taken, the owners have no other recourse than to receive the sum which the property they must continue to own will earn under the reduced rates.[92]

Turning to the specific question before him, Justice Brewer emphasized that the Nebraska legislation would reduce local freight rates an average of 29 1/2 per cent below the rates then in effect. After examining the operating results for the railroads—their construction costs, bonded indebtedness, revenues, operating expenses, and profits for the last three fiscal years—he concluded that reductions of that magnitude were "unjust and unreasonable to those who have invested their money in these railroad properties," and restrained enforcement of the statute.[93]

On appeal to the Supreme Court, Justice Harlan, speaking for six members of the Court, affirmed Brewer's finding that the legislation involved violated the constitutional rights of the railroads and their owners.[94] Harlan first set forth the proposition—which was to have considerable import in future rate regulation litigation—that the complainants were entitled to sue for an injunction to protect their

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91. *Id.* at 177.

92. *Id.* at 178.

93 *Id.* at 189.

94. Harlan did not expressly adopt Brewer's analogyzing of rate regulation to an eminent domain taking. Perhaps he did not because he had stressed in prior opinions the necessity for the government to assert a proprietary interest for itself to constitute a "taking". *See* Sax, *Takings and the Police Power*, 74 YALE L.J. 36, 38-39 (1964).

Constitutional rights in federal courts even though they had an alternative right to seek relief in the courts of the state involved.[95] Further, he agreed that it was proper to test the prospective rates by ascertaining the results if the rates had been in effect for any of the three preceding years.[96] He accepted Brewer's conclusion that four of the six railroads could not have recouped their operating expenses in any of those years had the legislative rates been in effect.[97]

However, he departed from Brewer's analysis in evaluating the consequences of the fact that two of the railroads *could* have made a profit under those rates. The argument of the railroads (which Brewer emphasized[98]) that a railroad was entitled "to meet the interest regularly accruing upon its outstanding obligations and justify a dividend upon all its 'stock' "[99] was unacceptable to him because the actual cost of building the railroads was substantially greater than the cost of building them from scratch at the time of the litigation.[100] Nor was he willing to accept the argument of John L. Webster for Nebraska that any rate which more than covers operating expenses is constitutional and that the extent of excess over expenses is strictly a matter for the legislature.[101] Instead, Harlan adopted the test urged upon reargument for Nebraska by William Jennings Bryan[102] that the carriers were entitled only to a fair return on the "value" of their property. Harlan phrased the test in these words:

> 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, the present as compared with the original cost of construction, the probable earning capacity of the property under particular rates

95. Smyth v. Ames, 169 U.S. 466, 516-17 (1897).

96. *Id.* at 528-29.

97. *Id.* at 534.

98. 64 Fed. at 177-78, 186-88.

99. 169 U.S. at 543.

100. For example, the Union Pacific property was capitalized at a sum of $103,786 per mile. The reproduction cost of its property within Nebraska was $20,000 per mile. Ames v. Union Pacific R. Co., 64 Fed. 165, 185-87 (D. Neb. 1894). This was due in part to the price level trend which was steadily downward from 1865 to 1897. M. GLAESER, PUBLIC UTILITIES IN AMERICAN CAPITALISM 301 (1957) [hereinafter cited as GLAESER].

101. 169 U.S. at 478-86.

102. *Id.* at 486-94.

> 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 is exacted from it for the use of a public highway than the services rendered by it are reasonably worth.[103]

Without further discussion on the point, Harlan concluded 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.[104]

With the hindsight of history, it is easy to criticize the *Smyth* "fair return on fair value" test. It did not appear to help Justice Harlan in reaching his decision; if he used it in deciding what weight to attach to the two utilities that might have made a profit under the prescribed rates, he does not show us how. His opinion reads as well without the "fair-value" discussion as it does with it.[105] Moreover, the test is so vague and general that it furnishes little guidance in determining the outcome of other cases. No one has the slightest idea as to what the "value" of a public utility property is, even without adding that the "value" must be "fair" rather than "unfair". The list of Harlan's "matters for consideration" does not help very much, because the list is concededly incomplete, and no formula is presented for giving each matter "such weight as may be just and right in each case."[106]

But in the context of its time, *Smyth* was a significant and "wise" decision—as much for what it rejected as for what it accepted. State legislatures were put on notice that there were Constitutional limits on the extent to which they could coerce favorable treatment for their residents from the railroads that brought the goods of all to market. Entrepreneurs received assurance that extensive capital investments could be undertaken without fear that they would be made profitless by

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103. *Id.* at 546-47.

104. *Id.* at 547.

105 *See* PEGRUM 216.

106. *See* Brandeis' criticism in Missouri *ex rel.* Southwestern Bell Tel. Co. v. Public Serv. Comm'n, 262 U.S. 286, 297 (1923) (dissenting opinion). *See also* note 110 *infra* and accompanying text.

squabbles between the states the railroads served.[107] The railroad magnates, however, did not get everything that they wanted. There was no assurance that every dollar of investment would be a profitable one. If an investment did not provide a proven benefit to the consumers, it could be disregarded for rate purposes. Overcapitalization or fraud or falling prices would adversely affect the stockholders rather than the ratepayers. In short, the decision was a general compromise between the positions of both parties—a "masterpiece of straddling" in the words of one commentator.[108]

Moreover, the decision had a substantial impact on the manner in which states were to regulate utilities. No rate reduction could be ordered, for whatever reason, unless courts could be convinced that the resulting rates afforded the utility a "fair return on fair value". Therefore, any state wishing to reduce a rate had to examine the consequences of its action on "fair value" to ensure that it was not wasting its time. Also, under the *Chicago, Milwaukee* decision, the utility had to have a full judicial hearing before it could be forced to comply with the rate order. These requirements probably encouraged the states to transfer rate-fixing from the halls of the legislature to special regulatory commissions, where all the factors could be considered and where incidentally the utility probably could present its case more effectively and persuasively.[109]

C. *Smyth to Southwestern: Review in Theory*

Having established its right to final rate-making authority in *Smyth*, the Court withdrew as an active participant in the rate-fixing process for 25 years. It continued to acknowledge the necessity for rates to afford the utility a "fair return on fair value", but it consistently refused to conclude that either the value set or the return afforded in any given case was not "fair."[110] Especially when rates were attacked before they

107. Interstate rivalries appear to have been a major motivating factor in the enactment of the early regulatory legislation. Thus, one justification of the reasonableness of the legislatively-prescribed maximum rates involved in *Smyth* was that the legislation merely provided the people of Nebraska with rates as low as those paid by people in Iowa. Ames v. Union Pacific R.R., 64 Fed. 165, 188 (D. Neb. 1894).

108. Aitchison, *Fair-Return-on-Value Theory in Rate Making Loses Force*, 25 ICC PRAC. J. 11, 12 (1957). *See also* TWISS 63.

109. WELCH 577. *See also* Beutel, *Valuation as a Requirement of Due Process*, 43 HARV. L. REV. 1249, 1258-74 (1930).

110. *E.g.*, San Diego & Town Co. v. Jasper, 189 U.S. 439, 441-42 (1903); Stanislaus County v. San Joaquin & King's River C. & I. Co., 192 U.S. 201, 213-14 (1904); City of Knoxville v. Knoxville

became effective, utilities were told that they had the burden of proving confiscation "by definite and convincing proof"[111] and that the Court much preferred that the rates be tested in actual operation before litigation.[112]

The Court's lack of interest in the power it had awarded itself was consistent with other national trends during the period of 1900-1918. Reform had become "respectable"—the Grange was dead, Populism had given way to the Progressive Movement, and leadership had shifted from the radical William Jennings Bryan to the more acceptable Theodore Roosevelt, Charles Evans Hughes and Robert M. LaFollette.[113] The economy was strong and the country was in the midst of an era of economic and territorial expansion.[114] Under the leadership of a new Chief Justice, Edward D. White, the Supreme Court eased off in many spheres from the strong pro-capitalist position it had adopted during the 1890's.[115]

D. Southwestern to West: Review in Fact

This progressive era came to an abrupt end at the close of World War I. The "War to End All Wars" gave way to the frustrations of the

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Water Co., 212 U.S. 1, 8 (1909); Willcox v. Consolidated Gas Co., 212 U.S. 19, 42 (1909); City of Louisville v. Cumberland Tel. & Tel. Co., 225 U.S. 430, 436 (1912); Minnesota Rate Cases, 230 U.S. 352, 466-67 (1913); Missouri Rate Cases, 230 U.S. 474, 501, 508-09 (1913); Allen v. St. Louis, Iron Mountain & Southern Ry. Co., 230 U.S. 553, 560 (1913); Des Moines Gas Co. v. City of Des Moines, 238 U.S. 153, 171 (1915); Manufacturers Ry. Co. v. United States, 246 U.S. 457, 489-90 (1918); Lincoln Gas & Electric Co. v. City of Lincoln, 250 U.S. 256, 262 (1919); Brush Electric Co. v. City of Galveston, 262 U.S. 443, 446 (1923). In 1923, Justice Bradeis stated that the Supreme Court since *Smyth* had passed upon the quetion of whether state-fixed rates denied the utility a fair return on fair value in 25 cases, and that in none of the cases did the Court find either the rate base or return percentage to be too low. Missouri *ex rel.* Southwestern Bell Tel. Co. v. Public Serv. Comm'n, 262 U.S. 286, 297 (1923) (dissenting opinion). *But see* Beutel, *Due Process in Valuation of Local Utilities*, 13 MINN. L. REV., 409, 434-36 (1929).

111. Allen v. St. Louis, I. M. & S. Ry., 230 U.S. 553 (1913).

112. City of Knoxville v. Knoxville Water Co., 212 U.S. 1, 17-18 (1909); Willcox v. Consolidated Gas Co., 212 U.S. 19 (1909); City of Louisville v. Cumberland Tel. & Tel. Co., 225 U.S. 430 (1912); Lincoln Gas & Electric Co. v. City of Lincoln, 250 U.S. 256 (1919); Brush Electric Co. v. City of Galveston, 262 U.S. 443 (1923).

113. The distinctive characteristics of the Progressive Movement are outlined in Mowry, *The Progressive Movement*, in INTERPRETING AMERICAN HISTORY II-99 (J. Garraty ed. 1970).

114. *See, e.g.*, KIRKLAND 441-63; PARKER 518-42; DULLES 156-77.

115. *See, e.g.*, Muller v. Oregon, 208 U.S. 412 (1908); Standard Oil Co. v. United States, 221 U.S. 1 (1911); Minnesota Rate Cases, 230 U.S. 352 (1913); German Alliance Insurance Co. v. Kansas 223 U.S. 389 (1914); Wilson v. New, 243 U.S. 332 (1917); *See also* JACOBS 94-95; 2 C. WARREN, THE SUPREME COURT IN UNITED STATES HISTORY 718-56 (1926); Watts, *Edward Douglas White*, in 3 JUSTICES OF THE UNITED STATES SUPREME COURT (1789-1969) 1633 (L. Friedman & F. Israel ed. 1969).

Versailles negotiations, the battle over American entry into the League of Nations and the collapse of President Wilson's leadership. Fear of communism, anarchism and radicalism turned communities against labor unions and foreigners.[116] The economy suffered from a ruinous wartime inflation followed by a demobilization and depression.[117]

As the 1920's began, the nation sought "normalcy",[118] meaning an abandonment of the reforms of the previous twenty years. On the Supreme Court, William Howard Taft took over as Chief Justice; in the ten years he presided, 1921 to 1930, more acts of Congress and more state statutes were invalidated than in any other ten-year period in the Court's history.[119] The neglected theory of Justices Field and Brewer that only a limited class of businesses could be subjected to regulation finally found majority acceptance, and state laws seeking to regulate meat packing,[120] ticket brokers,[121] employment agencies,[122] retail gasoline,[123] and the ice business[124] were set aside as unconstitutional.

Starting from the premise that courts had a constitutional duty to determine all questions of confiscation "according to their own independent judgment" "as to both law and facts,"[125] the Court began in 1923 to convert the general guidelines of *Smyth* into a set of rigid directives eliminating any possibility of regulatory discretion or choice. Prior to World War I, the price level had been sufficiently stable that the various criteria suggested in *Smyth* would all lead to roughly comparable results. However, the World War I inflation drove the general price level to a significantly higher level. Thereafter, the criteria selected could have a significant effect on the outcome.[126] In an

116. The events barely outlined in the first three sentences of this paragraph are analyzed in depth in R. MURRAY, RED SCARE: A STUDY IN NATIONAL HYSTERIA (1955).

117. Prices rose steadily from 1914 to May, 1920. The index of wholesale prics rose from 100 in 1913 to 227.9 for 1920. The cost of living in 1920 was 105 per cent above that of 1914. The economy then turned around abruptly in "one of the most violent crashes of prices that the nation has ever experienced." The wholesale price index plummetted in one year from 227.9 to 150.6. G. SOULE, PROSPERITY DECADE 84, 96 (1947). *See also* GLAESER 301; KIRKLAND 467.

118. The word was apparently coined by Warren G. Harding in a May, 192, speech in Boston in which he urged a return to "not heroism, but healing, not nostrums but normalcy." W. LEUCHTENBERG, THE PERILS OF PROSPERITY, 1914-32 89 (1958).

119. McKay, *The Supreme Court as an Instrument of Law Reform*, 13 ST. L.U.L.J. 387, 390 (1969).

120. Wolff Packing Co. v. Court of Industrial Relations, 262 U.S. 522 (1923).

121. Tyson & Bros. v. Banton, 273 U.S. 418 (1927).

122. Ribnick v. McBride, 277 U.S. 350 (1928).

123. Williams v. Standard Oil Co., 278 U.S. 235 (1924).

124. New State Ice Co. v. Liebmann, 285 U.S. 262 (1932).

125. Ohio Valley Water Co. v. Ben Avon Borough, 253 U.S. 287, 289 (1920).

126. GLASER 314; PEGRUM 217.

unsurprising reversal of roles, utilities began to press for the adoption of William Jennings Bryan's "present value" as the key to "fair value", while the consumers became advocates of the "actual investment" test.[127]

In the 1923 case of *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission*,[128] the Court bought the utilities' argument. An order of the Public Service Commission reducing exchange telephone rates was reversed on the ground that the resulting revenues would provide the company with only a "possible 5 1/2 per cent return on the minimum value of the property, which is wholly inadequate, considering the character of the investment and interest rates then prevailing."[129] In the course of the majority opinion, Justice McReynolds gave constitutional sanctification to the "present value" test:

> It is impossible to ascertain what will amount to a fair return upon properties devoted to public service without giving consideration to the cost of labor, supplies, etc. at the time the investigation is made. An honest and intelligent forecast of probable values made upon a view of all the relevant circumstances, is essential. If the highly important element of present costs is wholly disregarded such a forecast becomes impossible. Estimates for tomorrow cannot ignore prices of today.[130]

Justice Brandeis concurred, in a lavishly praised[131] and subsequently significant opinion. He agreed that the commission's order should be reversed, but only because it "prevents the utility from earning a fair return on the amount invested in it."[132] The bulk of his opinion was devoted to an attack on the rule of *Smyth v. Ames* as "legally and economically unsound",[133] criticism of cost of reproduction as an appropriate factor in the determination of the "property" entitled to constitutional protection, and an argument for the adoption of a "prudent investment" standard.

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127. This change of position apparently troubles some economists, *e.g.*, D. LOCKLIN, ECONOMICS OF TRANSPORTATION 356 (6th ed. 1966).

128. 262 U.S. 276 (1923).

129 *Id.* at 288.

130. *Id.* at 287-88.

131. *Eg.*, BONBRIGHT 184 n. 15; 2 PRIEST 494; Frankfurter & Hart, *Rate Regulation*, in 13 ENCYC. SOC. SCI 104, 108 (E. Seligman ed. 1934); Dakin, *The Changing Nature of Utility Rate Regulation*, 36 TUL. L. REV. 401, 416-18 (1962); Goddard, *The Problem of Valuation*, 41 HARV. L. REV 564 n. 2, 570, 579-80 (1928); Richberg, *The Supreme Court Discusses Value*, 37 HARV. L. REV 289, 293 *passim* (1924).

132. Missouri *ex rel.* Southwestern Bell Tel. Co. v. Public Serv. Comm'n, 262 U.S. 276, 289 (1923).

133. *Id.* at 290.

Brandeis attacked *Smyth* on several grounds. First of all, utility property had no "value" in the economic sense. Utilities had no exchange value, because they were not bought and sold on the market. Nor could their values be determined by capitalizing net earnings, because earnings are a function of rates, and rates could not be known until after the proceeding had terminated. Moreover, the various factors mentioned in *Smyth*—original cost, reproduction cost, present value, value of stocks and bonds—were themselves inconsistent and could lead to widely varying results, depending on what weight was given to each factor.[134] Finally, when the rule was used by a commission to set rates, rather than by a court to test rates set on a different basis, the margin between "a reasonable rate and a merely compensatory rate" was eliminated, and effective judicial review was almost impossible.[135] If a commission was shrewd enough to recite in its opinion that it considered all of the relevant factors, its order would probably stand regardless of where it set the actual rate level.[136]

He argued that "cost of reproduction" should not be used because it no longer fulfilled a real need and it was unjust to investors and consumers alike. Reproduction cost had originally been used because utilities often had inadequate and unreliable records of their actual investment expenses, and their construction methods were frequently wasteful. Engineering estimates of present replacement costs appeared much more reliable by comparison. But over the years, commissions have forced utilities to keep much more honest and accurate books, and the supposed reliability of engineers' calculations has proved to be delusive. The continued use of reproduction cost was unfair because it punished investors when prices receded and consumers when they rose.[137]

Brandeis urged instead the adoption of "the amount prudently invested" as the rate base and "the amount of the capital charge" as the measure of fair return.[138] These criteria would be fixed and unchanging through time, and thereby eliminate the uncertainty that forced capital costs up.[139] Because he felt they would be so easy to determine, they would also eliminate the expense of recurrent rate controversies. Especially because accounting reforms made the adoption of such

134. *Id.* at 292-96.
135. *Id.* at 296-98.
136. *Id.* at 296 n. 8.
137. *Id.* at 298-306.
138. *Id.* at 306.
139. *Id.* at 306-07.

approaches immediately feasible, Brandeis urged that it should be done.[140]

Brandeis' opinion is praiseworthy for its attack on *Smyth* and reproduction cost, but his "prudent investment" alternative offers little improvement. Brandeis did not quarrel with the proposition that courts should not allow rate regulation to deprive utility owners of the "value" of their interest; however, he felt that the owners' interest was not specific land or buildings but the capital to purchase those assets. Therefore, he felt the constitutional minimum should be a "fair return" on the capital itself and not on the property for which it had been exchanged.[141] To return to Justice Brewer's analysis, Brandeis agreed that there was a "taking", but said it should be considered as a taking of money and not of property.

The advantages claimed by Brandeis for his "prudent investment" theory are questionable at best. His argument, that the "property" of an owner is his capital investment and not the assets purchased with it, would apply with equal force to any "taking" under the eminent domain power. The problem is that, over time, the amounts expended for given assets tend to lose significance as either a measure of the "true" contribution of the owners or the value of those assets to the public.[142] Moreover, as Brandeis himself conceded, "prudent investment" is a one-way street—when the investment is greater than the value at hearing time, rates based on investment could be rejected as "unduly burdensome to the public."[143]

The argument that "prudent investment" is "fairer" than "present value" is obviously fallacious. In inflationary periods, "prudent investment" favors consumers and "present value" favors investors; in a depression, the reverse is true. The question of which is "fairer" depends exclusively on whether the evaluator considers inflation more likely than depression, and whether he prefers consumers or investors.[144]

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140 *Id.* at 309-310.

141 *Id.* at 290. *See* GLAESER 318.

142 BONBRIGHT 159-60.

143. Missouri *ex rel.* Southwestern Bell Tel. Co. v. Public Serv. Comm'n, 262 U.S. 276, 290, n. 2. For a persuasive discussion of the inequities of such inconsistency *see* Morton, *Rate of Return and the Value of Money in Public Utilities*, 28 J. LAND ECON. 91 (1952).

144 *Cf.* Richberg, *The Supreme Court Discusses Value*, 37 HARV. L. REV. 289, 298 (1924): Fluctuations of the currency have effects similar to the actions of the elements. They bring fortune and misfortune to individuals quite indiscriminately, with one broad qualification: on the whole it appears that the debtor class is usually less able to protect itself from injury than the Creditor Class." Somers argues that neither test is sufficiently meaningful to help

Brandeis based his argument on the prediction that prices would be stable in the long-run, and that therefore "prudent investment" would tend to ignore short-term fluctuations.[145] History has proven him a false prophet.

Brandeis' belief that definiteness and certainty could be imported into rate controversies by using "prudent investment" to measure the rate base and "cost of capital" to fix rate of return has also proved to be illusory. "Prudent investment" cannot be measured as easily as Brandeis thought:

> The rate base would be ascertained as a fact, not determined as a matter of opinion . . . . It would, when once made in respect to any utility, be fixed for all time, subject only to increases to represent addition to plant, after allowance for the depreciation included in the annual operating charges.[146]

Brandeis' simplistic formula overlooks the problems such as inter-company transfers, determining which assets are "used and useful", changes in efficiency or life expectancy, effect of prior depreciation or amortization charges, changes in replacement costs or general price levels—all of which can produce a great gap between the utility's original book entries and its "prudent investment" for rate purposes.[147] Similarly, Brandeis' notion that the cost of equity capital could be calculated on the basis of "the economic obligation to pay dividends" at the time of issuance is not workable. In essence, it would convert utility common stock into a species of income bond, and would require investors to demand a high enough return at the outset to cover all possible risks for the indefinite future. Brandeis' theories might work for a stagnant utility in a stable price economy, but they have little relevance to the real world of rate regulation.[148]

Brandeis was able to muster a majority of the Court later that year to support his statement in *Georgia Railway & Power Co. v. Railroad Commission of Georgia* that "[t]he refusal of the commission . . . to

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either investors or customers and that consequently "we are in difficulty no matter what we do with the rate base.

Somers, *The 'End Result' Approach to Public Utility Regulation*, 16 BUFF. L. REV. 689, 695 (1967).

145. Missouri *ex rel.* Southwestern Bell Tel. Co. v. Public Serv. Comm'n, 262 U.S. 276, 302-03 (1923).

146. *Id.* at 306-07.

147. BONBRIGHT 159-69.

148. This is apparently the practice that had been followed in Great Britain. The most recent call for its adoption in this country seems to be J. BAUER, TRANSFORMING PUBLIC UTILITY REGULATION (1950).

hold that, for rate-making purposes, the physical properties of a utility must be valued at the replacement cost, less depreciation, was clearly correct."[149] But on the same day, in *Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia*, the Court also supported Justice McReynolds' doctrine in the *Southwestern Bell* majority opinion that rates must be "sufficient to yield a reasonable return on the value of the property used, at the time it is being used to render the service."[150]

McReynolds' theories prevailed for the remainder of the decade. In *McCardle v. Indianapolis Water Co.*,[151] the Court held not only that rates must be based on the reproduction cost of a utility's property, but also that the reproduction cost must be calculated from the prices prevailing at the time of the effective date of the rate order and could not be based on average prices in the preceding ten year period. In *St. Louis & O'Fallon Railway Co. v. United States*,[152] it held that the Interstate Commerce Commission had no discretion to refuse to consider reproduction cost even where the only reproduction cost figures before it had no probative value. And in *United Railways & Electric Co. v. West*, the Court refused to accept rates as constitutionally adequate unless "after paying all expenses of operation, setting aside the necessary sums for depreciation, payment of interest and reasonable dividends, there should still remain something to be passed to the surplus account."[153]

Thus, by 1930, the Supreme Court completely dominated utility rate regulation. A utility had a Constitutional right to take any adverse rate order to federal court, where it would receive "the independent judgment of the court as to both law and facts." The Court had to be convinced that the utility was receiving in excess of its costs a "fair return" (as defined by the Supreme Court) on the "fair value" (as defined by the Court) of its "property" (as defined by the Court). In order to protect its orders from court reversal, regulatory commissions had a strong compulsion to use the judicial tests in their own deliberations; indeed, before the end of the decade, the Court held that a commission could not constitutionally refuse to consider evidence directed to those criteria.[154] The control of the Court was complete.

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149 262 U.S. 625, 630 (1923).

150. 262 U.S. 679, 690 (1923). Only Justice McKenna noticed that the decisions in the two cases were obviously inconsistent. Georgia Ry. & P. v. Railroad Comm'n, 262 U.S. 625, 634 (1923).

151. 272 U.S. 400 (1926).

152. 279 U.S. 461 (1929).

153. 280 U.S. 234, 251-52 (1930).

154. Northern Pac. Ry. v. Department of Pub. Works of Washington, 268 U.S. 39 (1925).

E. The Great Retreat: Johnson to Hope

The *West* case in 1930 represents the high-water mark for the Supreme Court as rate-maker. The worldwide economic collapse of the 1930's undoubtedly influenced the Court to relax its absolute conceptions of liberty and property.[155] So did the departure from the Court of men like Chief Justice Taft and Justices McKenna and Sanford and their replacement by the more moderate Hughes, Stone and Roberts. With the ushering in of the New Deal, the Court began to retreat from—and be driven out of—the rate regulation business.

The prior era of federal judicial rate regulation had had its most deleterious effects on the activities of state regulatory commissions. Since the *Smyth* decision, utilities had been afforded the right to contest an adverse state commission decision in federal court immediately upon its issuance. Because the United States Judicial Code made no provision for the certification of the record of a state administrative body, the federal court had to make its own *de novo* determinations of the value of the property involved and the return that the proposed rates would yield on that valuation. As a result, the presentation before the commission was looked upon largely as a mere formality that wasted much time and money. The real test occurred in the federal court, usually before a special master, and involved "the seemingly anomalous situation of bringing the Commission before [the federal court] as a defendant, forced to justify in a protracted trial the rates that it was created by the state itself to administer."[156]

The Court began the retreat from its prior position as strict supervisor of all rate-making determination on its own initiative. In 1933, in *Los Angeles Gas & Electric Corp. v. Railroad Commission of California*,[157] Chief Justice Hughes refused to disturb a commission order reducing natural gas rates in California. Returning to the language of the pre-1920 decisions, he emphasized that

> . . . the judicial function does not go beyond the decision of the constitutional question. That question is whether the rates as fixed are confiscatory. And upon that question the complainant has the burden of

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Curiously, the *Northern Pacific* opinion was written by Justice Brandeis who had argued in *Southwestern Bell* that the consideration of such questions by regulatory commissions completely frustrated the intentions of *Smyth v. Ames*. *See* note 135 *supra* and accompanying text.

155. Lerner, *The Supreme Court and American Capitalism*, 42 YALE L.J. 668, 700 (1933).

156. Donovan, *Report of Counsel*, in REPORTS OF NEW YORK STATE COMMISSION ON REVISION OF THE PUBLIC SERVICE COMMISSION LAW 63 (Leg. Doc. No. 75 1930).

157. 289 U.S. 287 (1933).

> proof and the Court may not interfere with the exercise of the state's authority unless confiscation is clearly established.[158]

The opinion emphasized that actual cost and cost of reproduction were both entitled to "appropriate consideration", but that "[t]he weight to be given to actual cost, to historical cost and to cost of reproduction new, is to be determined in the light of the facts of the particular case."[159] The Court totally rejected the company's theory, that rates should be based on 1927-1929 prices because prices for the years after 1930 would be at approximately the 1929 level, with the curt comment that

> . . . the rate base as fixed by the Commission is not to be invalidated as involving confiscation by reason of these estimates which the course of events deprived of credit as trustworthy prophecies.[160]

Justice Butler dissented, declaring that the rates were "arrived at by arbitrary methods condemned by our decisions,"[161] but only Justice Sutherland joined him.

In spite of the more englightened attitude indicated in *Los Angeles Gas* and the subsequent cases of *Lindheimer v. Illinois Bell Telephone Company*[162] and *West Ohio Gas Company v. Public Utilities Commission of Ohio*,[163] the Court refused to totally abandon its strict scrutiny of rate regulation cases. Thus, in *West v. Chesapeake & Potomac Telephone Co.*,[164] it reversed a rate reduction order solely because the Maryland commission had based its findings as to the "value" of the utility's property on general price indices for the period 1923-1932. Similarly, in *St. Joseph Stock Yards v. United States*, the Court reaffirmed its declaration that any rate order "is necessarily subject to independent judicial review upon the facts and the law by courts of competent jurisdiction to the end that the Constitution as the supreme law of the land may be maintained."[165] The latter opinion provoked Justice Brandeis to declare:

> The inexorable safeguard which the due process clause assures is not that a court may examine whether the findings as to value or income are correct, but that the trier of the facts shall be an impartial tribunal; that

158 *Id.* at 304.
159 *Id.* at 308.
160 *Id.* at 311-12.
161. *Id.* at 315.
162 292 U.S. 151 (1934).
163 294 U.S. 79 (1935).
164 295 U.S. 662 (1934).
165. 298 U.S. 38 (1936).

> no finding shall be made except upon due notice and opportunity to be heard; that the procedure at the hearing shall be consistent with the essentials of a fair trial; and that it shall be conducted in such a way that there will be opportunity for a court to determine whether the applicable rules of law and procedure were observed.[166]

Justices Stone and Cardozo agreed that "the opinion of Mr. Justice Brandeis states the law as it ought to be" but added that they "appreciate the weight of precedent that has now accumulated against it."[167]

In the midst of this groping by the Justices for their appropriate function in the rate-making process, Congress stepped in to set a sharp limit on the vulnerability of state rate orders to independent federal court actions. In 1934 the Johnson Act was passed, which provides:

> The district courts shall not enjoin, suspend or restrain the operation of, or compliance with any order affecting rates chargeable by a public utility and made by a State administrative agency or a rate-making body of a State political subdivision, where:
>
> (1) Jurisdiction is based solely on diversity of citizenship or repugnance of the order to the Federal Constitution; and
>
> (2) The order does not interfere with interstate commerce; and
>
> (3) The order has been made after reasonable notice and hearing; and
>
> (4) A plain, speedy and efficient remedy may be had in the courts of such state.[168]

Although the Supreme Court has not given a particularly expansive reading to the Johnson Act,[169] there is no doubt that the volume of federal court litigation over state rate-making has declined since the Act's passage. In part, this may be due to a greater willingness on the part of lower federal courts to decline jurisdiction in cases where the Act may apply.[170] But the prinicipal reason is undoubtedly the fact that the

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166. *Id.* at 73.

167. *Id.* at 93.

168. 28 U.S.C. § 1342 (1964).

169. For example, in Mountain States Power Co. v. Public Serv. Comm'n, 299 U.S. 167 (1936), the court held that a Federal suit to set aside a state rate order was not precluded by the statute where state law expressly prohibits issuance of any relief until the rate order is finally set aside by a state court. *See also* Driscoll v. Edison Light & Power Co., 307 U.S. 104 (1939).

170. *See, e.g.*, East Ohio Gas v. City of Cleveland, 94 F.2d 443 (6th Cir. 1938); City of El Paso v. Texas Cities Gas Co., 100 F.2d 501 (5th Cir. 1938); Mississippi Power & Light Co. v. City of Jackson, 116 F.2d 924 (5th Cir. 1941); City of Meridian v. Mississippi Valley Gas Co., 214 F.2d 525 (5th Cir. 1954); Kansas-Nebraska Gas Co. v. City of St. Edward, 135 F. Supp. 629 (D. Neb. 1955).

Supreme Court since 1938 has not been hospitable to the plaints of utility companies for protection of their property from the actions of regulatory agencies.

The Court finally loosened the judicial bonds on rate-making in the early 1940s, with its decisions in *Federal Power Commission v. Natural Gas Pipeline Co.*[171] and *Federal Power Commission v. Hope Natural Gas Co.*[172] The *Natural Gas* case was a challenge to an FPC rate reduction order under the Natural Gas Act of 1938. Before reviewing (and rejecting) the utilities' challenge to the rate order, Chief Justice Stone, speaking for a Court unanimous in its approval of the Commission order, defined the scope of judicial review. In his view, the judicial review provided for in the Gas Act "coincides with that of the Constitution" and therefore the courts had no power to set aside any rate order that was not confiscatory in the constitutional sense.[173] He then proceeded to "restate" the constitutional test in a striking new formulation:

> The Constitution does not bind rate-making bodies to the service of any single formula or combinations of formulas. Agencies to whom this legislative power has been delegated are free, within the ambit of their statutory authority, to make the pragmatic adjustments which may be called for by particular circumstances. Once a fair hearing has been given, proper findings made, and other statutory requirements satisfied, the courts cannot intervene in the absence of a clear showing that the limits of due process have been overstepped. If the Commission's order, as applied to the facts before it and viewed in its entirety, produces no arbitrary result, our inquiry is at an end.[174]

Thus, Stone seemed to postulate two constitutional requirements for rate-making orders: a procedural requirement of "fair hearing, proper findings" etc., and a substantive requirement that the "limits of due process" not be "overstepped." This latter test appeared to turn on whether the order "in its entirety" produced an "arbitrary result".

Justices Black, Douglas and Murphy disagreed with the Chief Justice's statement that "the due process clause . . . grants [the Court] power to invalidate an order as unconstitutional because it finds the charges to be unreasonable." These Justices thought it "an appropriate occasion to lay the ghost of *Smyth v. Ames* . . . which haunted utility

171. 315 U.S. 575 (1942).
172. 320 U.S. 591 (1944).
173. 315 U.S. at 585.
174. *Id* at 586.

regulation since 1898."[175] Unfortunately, these Justices laid the wrong ghost. Rather than freeing commissions to adopt any rates that appear appropriate to them as regulators, the three concurring Justices merely indicated their willingness to allow commissions to adopt Brandeis' "prudent investment" rate base. Although they felt the courts should not "concern themselves with any issues as to the economic merits of a rate base",[176] they were apparently unwilling to consider the possibility that a commission might use no rate base at all. Retreating from the initially announced purpose to abandon any judicial scrutiny of the reasonableness of rates, their concurrence asserted that "just and reasonble" rates require that consideration be given to both the investor interest" and the "consumer interest". With respect to investors, they felt:

> Irrespective of what the return may be on 'fair value,' if the rate permits the company to operate successfully and to attract capital, all questions as to 'just and reasonable' are at an end so far as the investor interest is concerned.[177]

The "consumer interest" was disposed of with the "caveat" that such interest "cannot be disregarded."[178]

Justice Frankfurter filed a brief concurrence, chiding Black, Douglas and Murphy for the inconsistency between their professed aim and their inability to see beyond the adoption of a different rate base measure. In Frankfurter's words,

> . . . if it be deemed that courts have nothing to do with rate-making because that task was committed exclusively to the Commission, surely it is a usurpation of the Commission's function to tell it how it should discharge this task and how it should protect the various interests that are deemed to be in its and not in our keeping.[179]

Hope, which is an expansion of the three-judge concurrence in *Natural Gas*, is generally considered to provide the current constitutional test for rate-making.[180] Douglas, for the majority, emphasized that courts were

175. *Id.* at 602.
176. *Id.* at 606.
177. *Id.* at 607.
178. *Id.* at 607-08.
179. *Id.* at 610.
180. *See, e.g.*, PHILLIPS 264; Note, *An Earnings-Price Approach to Fair Rate of Return in Regulated Industries*, 20 STAN. L. REV. 287 (1968). *See also* 2 PRIEST 494; Nelson, *Economic Criteria and the Allowable Rate of Return*, in RATE OF RETURN UNDER REGULATION 3-29 (H. Trebing & R. Howard eds. 1969).

concerned only with the "impact", "total effect" or "consequences" of an order, and not with "theory" or "infirmities in method".[181] In language that has been subjected to minute subsequent scrutiny,[182] he defined the manner in which the "investor interest" must be protected in the rate-making process:

> . . . 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 . . . .[183]

After approving the rates ordered by the FPC in the particular case, Douglas went on to remark:

> 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.[184]

Douglas' opinion contained further language to indicate that a commission needed explicit statutory authority before it could set rates on any basis other than a conventional rate base approach. In rejecting the argument that rates should be set to discourage the use of natural gas for industrial purposes, he noted:

> The difficulty is that § 4(a) and § 5(a) [of the Natural Gas Act of 1938] contain only the conventional standards of rate-making for natural gas companies . . . . If the standard of 'just and reasonable' is to sanction the maintenance of high rates by a natural gas company because they restrict the use of natural gas for certain purposes, the Act must be further amended.[185]

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181. 320 U.S. at 602.

182 The extreme example is Leventhal, *Vitality of the Comparable Earnings Standard for Regulation of Utilities in a Growth Economy*, 74 YALE L.J. 989 (1965).

183 320 U.S. at 603.

184 *Id.* at 605. Douglas also cryptically commented that the Court's disposition of the case made it unnecessary to "stop to inquire" whether the Commission should have added $17,000,000 to the rate base. The total rate base allowed was only $34,000,000.

185. *Id.* at 616-17.

Justice Jackson filed a lengthy, brilliant[186] opinion. He professed absolute ignorance of the basis of his colleagues' decision:

> The Court sustains this order as reasonable, but what makes it so or what could possibly make it otherwise, I cannot learn.[187]

He argued that "a rate base is little help in determining reasonableness of the price of gas" because in that business "there is little more relation between the investment and the results than in a game of poker".[188] He argued that the case should be remanded for reconsideration to the Commission, free from any requirement that the prices for gas "produce a fair return on the synthetic value of a rate base of an individual producer".[189] Instead, the Commission should be "free to face up realistically to the nature and peculiarity of the resources in its control, to foster their duration in fixing price, and to consider future interests in addition to those of investors and present consumers."[190]

It is difficult to dispute Justice Jackson's criticism of the majority opinion. Clearly, the majority erased the dogma that the Constitution required utility owners to be afforded a "fair return" on the "fair value" of their property. But it did not erase the other fundamental doctrine of the *Smyth* case that the courts must be the ultimate determiners of the reasonableness of regulated rates. It merely substituted for the "fair value" criterion the notion that the courts must now be convinced that the "end result" of the rate-making process provides "enough revenue not only for operating expenses but also for the capital costs of the business".[191]

The *Hope* case has not been interpreted by state courts as affording regulatory commissions much freedom beyond substitution of "prudent investment" for "present value" as the rate base measure. Several states have refused to even go that far, holding that "fair value" was required by local law, without regard to how permissive the federal law may have become.[192] Shortly after *Hope* was decided, state commissions in New

186. This characterization is not solely the judgment of the author. *See* BONBRIGHT 37.

187. 320 U.S. at 645-46.

188. *Id.* at 649.

189. *Id.* at 652.

190. *Id.* at 660.

191. *Id.* at 603.

192. Thus, the Iowa Supreme Court poignantly exclaimed in 1957:

> There are such things as eternal virtues and ultimate truths, particularly in the field of constitutional law. The constitutional guarantees against legislative confiscation and against the taking of private property without due process should and do mean the same in the year 1957 as they meant in the year 1909.

Iowa-Illinois Gas & Electric Co. v. Fort Dodge, 248 Iowa 1201, 1225, 85 N.W.2d 28, 41 (1957).

Hampshire,[193] Vermont,[194] and Wisconsin[195] issued rate orders "without determining any rate base, and without determining any specific figure as constituting a 'fair rate of return' on anything that may be claimed to be a proper rate base."[196] In all three cases, the commission orders were reversed by the state supreme courts.[197] Moreover, the reason for reversal was the same in all three instances—that rate base calculations were essential to make judicial review effective. As the Vermont Supreme Court put it:

> It is apparent, and it is shown by all the cases which we have read touching on this point, that in order to reach a fair judgment on rates to be fixed, it is necessary that a proper rate base and allowable expenses be determined . . . . The much discussed [Hope] case . . . did not change this rule for . . . this case did not reject judicial right to review as to reasonableness of rates and, obviously, if it be held that no yardstick is necessary whereby to test this question then judicial review as to reasonableness of rates would become utterly meaningless.[198]

Also, the United States Court of Appeals for the District of Columbia Circuit, has held that rate base calculations are essential "at least as a point of departure" or else "no anchor as it were, is available by which to hold the terms 'just and reasonable' to some recognizable meaning."[199]

The Supreme Court has shown little interest in protecting constitutional limitations on rate-making since the *Hope* decision was handed down. In *Market Street Railway Co. v. Railroad Commission of California*,[200] the Court refused to disturb rates set on a base of

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See also Illinois Bell Tel. Co. v. Illinois Commerce Comm'n, 414 Ill. 275, 287, 111 N.E. 2d 329, 336 (1953); New York Tel. Co. v. Public Serv. Comm'n, 309 N.Y. 569, 132 N.E.2d 847 (1956); Railroad Comm'n of Texas v. Houston Natural Gas Corp., 155 Tex. 502, 289 S.W.2d 559 (1956); Montana *ex rel.* Olsen v. Public Serv. Comm'n, 131 Mont. 104, 111, 308 P.2d 633, 637 (1957). *See generally* Priest, *The Public Utility rate Base*, 51 IOWA L. REV. 283, 284 (1966); Hoskins & Katz, *Substantive Due Process in the States Revisited*, 18 OHIO STATE L.J. 384 (1957).

193. New England Tel. and Tel., 30 N.H. P. S.C. 266 (1948).

194. New England Tel. and Tel., 75 P.U.R. (N.S.) 45 (Vt. Pub. Serv. Comm'n 1948).

195. City of Two Rivers v. Commonwealth Tel. Co., 70 P.U.R. (N.S.) 5 (Wis. Pub. Serv. Comm'n 1947).

196. *Id.* at 10.

197. New Hampshire: New England Tel. & Tel. v. State, 95 N.H. 353, 64 A.2d 9 (1949). Vermont: Petition of New England Tel. & Tel., 115 Vt. 494, 66 A.2d 135 (1949). Wisconsin: Commonwealth Tel. Co. v. Public Serv. Comm'n, 252 Wis. 481, 32 N.W.2d 247 (1948).

198. 66 A.2d at 138.

199. City of Detroit v. FPC, 230 F.2d 810, 817-18 (D.C. Cir. 1955), *cert. denied*, 352 U.S. 829 (1956).

200. 324 U.S. 548 (1945).

$7,950.000—the sum at which the company had offered to sell its moribund tramway service to the City of San Francisco—even though that sum was far below either the original cost or the reproduction cost of the Company's facilities. The Court commented that its *Hope* criteria for determining when there is enough revenue from the company's point of view

> . . . are inapplicable to a company whose financial integrity already is hopelessly undermined, which could not attract capital on any possible rate, and where investors recognize as lost a part of what they have put in . . . . Without analyzing rate cases in detail, it may be safely generalized that the due process clause never has been held by this Court to require a commission to fix rates on the present reproduction value of something no one would presently want to reproduce, or on the historical valuation of a property whose history and current financial statements showed the value no longer to exist, or on an investment after it has vanished, even if once prudently made, or to maintain the credit of a concern whose securities already are impaired. The due process clause has been applied to prevent governmental destruction of existing economic values. It has not and cannot be applied to insure values or to restore values that have been lost by the operation of economic forces.[201]

In *Colorado Interstate Gas Co. v. Federal Power Commission*,[202] the Court affirmed an FPC determination to value gas production facilities at their original cost rather than their higher market value as proven reserves (the question of whether the resulting rates were confiscatory was not in controversy). In his opinion for the majority, Justice Douglas defended his *Hope* test against the criticisms of Justice Jackson and others:

> In those cases [*Natural Gas* and *Hope*] we held that the question for the courts when a rate order is challenged is whether the order viewed in its entirety and measured by its end results meets the requirements of the Act. That is not a standard so vague and devoid of meaning as to render judicial review a perfunctory process. It is a standard of finance resting on stubborn facts.[203]

Most recently, the Court has had occasion to review the constitutional limitations on rate regulation in the *Permian Basin Area Rate Cases*,[204] in which it sanctioned the fixing of natural gas prices on a producing-

201. *Id.* at 566-67.
202. 324 U.S. 581 (1945).
203. *Id.* at 605.
204. 390 U.S. 747 (1968).

area-wide basis. The majority opinion, written by Justice Harlan, appears to indicate that the Court is ready to abandon even the limited scope of review of the substantive reasonableness of rates that it retained in *Hope*. Harlan was careful to point out that the effect of rates on the company or its investors is no longer the sole test of constitutionality:

> Regulation may, consistently with the Constitution, limit stringently the return recovered on investment, for investors' interests provide only one of the variables in the constitutional calculus of reasonableness . . . . Accordingly, there can be no constitutional objection if the Commission, in its calculation of rates, takes fully into account the various interests which Congress has required it to reconcile.[205]

Harlan went on to spell out in explicit detail the role that a reviewing court should play in the rate-making process:

> It follows that the responsibilities of a reviewing court are essentially three. First, it must determine whether the Commission's order, viewed in light of the relevant facts and of the Commission's broad regulatory duties, abused or exceeded its authority. Second, the court must examine the manner in which the Commission has employed the methods of regulation which it has itself selected, and must decide whether each of the order's essential elements is supported by substantial evidence. Third, the court must determine whether the order may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable. The Court's responsibility is not to supplant the Commission's balance of these interests with one more nearly to its liking, but instead to assure itself that the Commission has given reasoned consideration to each of the pertinent factors. Judicial review of the Commission's orders will therefore function accurately and efficaciously only if the Commission indicates fully and carefully the methods by which, and the purposes for which it has chosen to act, as well as its assessment of the consequences of its orders for the character and future development of the industry.[206]

Justice Douglas dissented, on the ground that the Court's action could not be reconciled with *Hope*.[207] None of his colleagues joined in the dissent.

Thus, with the *Permian* decision, the Court has completed a long

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205 *Id.* at 769-70.
206 *Id.* at 791-92.
207 *Id.* at 829.

circle back to almost where it started in *Munn*, 92 years previous. The Constitution no longer provides any special protection for the utility investor. Regulation is deemed no different from any other governmental action; it can "limit stringently" the profitability of his investment in endeavoring to balance the "broad public interests entrusted to its protection." The Court will examine the end product of a commission's order only procedurally, to ensure that the order is supported by "substantial evidence" and that "the Commission has given reasoned consideration to each of the pertinent factors." Within the limits of its statutory authority, a commission is free to select its methods of regulation and to evaluate the various interests involved in any problem as it sees fit. The "end result" no longer seems to be of any interest to the Court; it asks merely for indications that the result was reached fairly and rationally.[208] *Smyth v. Ames* is dead; the only remaining task is to convince the state courts and regulatory commissions to give it a speedy burial.

II. The Effects of Rate Base Regulation

Rate base regulation should be abandoned not only because it is no longer a federal constitutional imperative but also because it provides no benefits to consumers, investors or the public interest.

The consumer would be benefited if rate base regulation either afforded him "better" service (service that met his needs more satisfactorily) or "lower priced" service. It is hard to see how service will be improved. The only thing that rate base regulation can do, as the Supreme Court pointed out in *Market Street Railway*, is to "prevent governmental destruction of existing economic values."[209] Rate base regulation does nothing to induce utility managers to make the optimum use of their facilities and franchises or to reward them when they do so. In fact, by providing for a uniform dollar return without differentiating between alternative investment choices available to management, rate base regulation furnishes powerful incentives to utilities to concentrate their investments in areas with the lowest risk, in preference to riskier

208. It is possible to argue that the rationale of the *Permian* decision is applicable only to the inordinately complex problems of natural gas regulation. *See* 2 Priest 575-86. However, the broader reading given to the decision in the text of this article seems more consistent with the general attitude of the Court toward questions of substantive economic due process. *See* McCloskey, *Economic Due Process and the Supreme Court*, 1962 Sup. Ct. Rev. 34.

209. 324 U.S. at 567.

alternatives for which consumers might be willing to pay a higher price.[210]

Moreover, there is no reason to believe that rate base regulation can effect lower prices for the utility consumer. A utility that wishes to charge a higher price for a given service should not find rate base regulation to be a significant deterrent. Dr. Harry M. Trebing has described some of the strategies available to it:

> The first is to maintain excess capacity through an excessive spread between system capacity and peak requirements. The second alternative is to maintain high safety standards that require proportionally more capital. A third possibility is the selection of more capital-intensive combinations of plant that do not result in lower costs. Fourth . . . , there is an inducement toward increased equipment prices, or at best a minimum incentive to reduce such prices. Finally, there is an incentive to serve noncompensatory or peripheral markets at less than long-run marginal costs.[211]

To these should be added the obvious alternative that the utility managers could build up costs through expenditures of more direct personal benefit to themselves, such as high salaries, palatial offices, generous pensions, executive airplanes, and the like.[212] In short, rate base regulation provides consumers only with the assurance that undue quantities of money will not pass directly and openly from their pockets to the pockets of investors—and this is a negligible comfort, at best.

From the standpoint of the investor, rate base regulation could be beneficial if it could furnish him with either a more certain or a higher return on his investment. It does little to enhance the certainty of his return. Regulation cannot and will not protect him against loss occasioned by a decline in either general demand or demand for the specific services that his utility furnishes. If he is concerned about a possible decline in earnings during a period of inflationary cost

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210. Economists have pointed out that where the net revenues permitted b regulation are less than the amounts profit maximization would yield, the utility managers will typically be able to choose between a variety of output and price combinations, each of which would yield the allowable revenues. *See, e.g.*, Baumol & Bradford, *Optimal Departures from Marginal Cost Pricing*, 60 AM. ECON REV. 266, 266-67 (1970).

211. Trebing, *Common Carrier Regulation—The Silent Crisis*, 34 LAW & CONTEMP. PROB. 299, 314-15 (1969).

212. Williamson considers these to be "expense preferences"—expenses that have positive values for managers. O. WILLIAMSON, THE ECONOMICS OF DISCRETIONARY BEHAVIOR 33 (1964). He recognizes that public utilities have a particular incentive to increase them to avoid exceeding profit constraints, inducing a rate correction. *Id.* at 57-59.

increases, he knows that the prospect that the regulators may eventually grant a rate increase must be balanced against the probability that the utility will have to go through a lengthy rate case in order to get it.[213] Moreover, the very vagueness of the standards that the commissions apply makes it impossible to predict how much of an increase the commission will allow, if it allows anything at all. Finally, he also must realize that rate base regulation will require the managers of his utility to expend much of their time and energy on keeping profits within tolerable limits, rather than improving service or cutting costs.[214]

Similarly, he has no reason to believe that rate base regulation will yield him a greater return on his investment. Just as management has ample tools to keep prices high, a vindictive regulator can use rate base regulation to keep profits low. Legitimate expenditures can be disallowed as "imprudent". Calculations of the "fair rate of return" can always be made in such a way as to justify any resulting rates.[215] Even if the investor was relatively confident that the courts would ultimately protect him if his actual return got so low as to be "confiscatory", he should also realize that litigation is a slow and expensive process.[216] The only benefit he obtains is the knowledge that, in an era of high earnings "regulatory lag" will enable him to keep the excessive returns until such time as the cumbersome wheels of regulation can complete all the necessary turns to produce an effective rate reduction order.[217]

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213. He should also recognize that regulators will be inclined to minimize consumer protest by delaying price increases to utilities for as long as possible. Nelson, *Pricing and Resource Allocation*, in UTILITY REGULATION: NEW DIRECTIONS IN THEORY AND POLICY 58, 70 (W. Shepherd & T. Gies eds. 1966).

214. Beutel, *Due Process in Valuation of Local Utilities*, 13 MINN. L. REV. 409, 432 (1929); Note, *An Earnings-Price Approach to Fair Rate of Return in Regulated Industries*, 20 STAN. L. REV. 287, 292-93 (1968).

215. One suspects that, if the courts were to hold that the rate base must be measured by the number of red-headed men on the planet Mars, the commissions would come forward with figures precise to the last digit, with dissenting opnions from some of their members as to whether the count should include Martian women and minors. And, oddly enough, the resulting rate base would seem to justify the very rates of charge which the commission deems it expedient to enforce for unofficial reasons.

2 J. BONBRIGHT, VALUATION OF PROPERTY 1143 (1937). *See also* Reich, *The Law of the Planned Society*, 75 YALE L.J. 1227, 1243 (1966).

216. For example, the *Permian Basin* cases (*see* nn. 190-93 *supra* and accompanying text) were begun in 1960 and not decided until May 1, 1968. The legality of the rates for A. T. & T.'s Telpak service, a bulk private-line communications offering, have been under investigation by the FCC since September 7, 1961 and are unresolved as of the time of this writing—nine years later.

217. In fact, the argument has been made that "regulatory lag" has been the factor that saved

From the standpoint of the public interest, rate base regulation must be considered a total disaster. It wastes countless human and physical resources in pointless controversies. It undoubtedly has caused inefficient allocation of resources, both to the regulated enterprises and within them.[218] By formulating standards malleable at the will of the persons with ultimate authority, it has neither protected the consumer from extortionate prices and inferior service, nor provided for economy and efficiency in production.[219] During the period when it was enforced most severely, it overcrowded the courts, diverting their attention from other matters, and discouraged long-range planning by keeping a crucial cost factor indeterminate for intolerable periods of time.[220] Thus, there is reason to share Professor Richard A. Posner's gloomy conclusion that "we lack any reason to be confident that efforts to limit the profits of natural monopolists, to the extent that they are successful, result in a net social gain."[221]

III. CONCLUSION

In its historical context, rate base regulation played an important role in the growth and development of the American economy. Rates were being set for the vital railroad industry by consumer controlled state legislatures. Fearful that low rates would drive capital out of the industry entirely, the Supreme Court formulated the doctrine that rates must be high enough to afford utility owners a "fair return on the fair value" of their property. In time, this doctrine, modified to substitute "prudent investment" for "fair value", came to be the exclusive criterion for rate regulation. As a result, regulators limited their activities in the crucial pricing area to the elimination of excess profits and occasional correction of gross discrimination.

Regulation so limited does not meet the needs of present-day society. In the first place, it misdirects attention to the overall performance of a utility, ignoring the multitude of specific decisions that lead to the total

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regulation from being a critical influence to mediocrity and tardy technological progress. *See* the analysis of this argument in BONBRIGHT 262-65.

218. Nelson, *Pricing and Resource Allocation* in UTILITY REGULATION: NEW DIRECTIONS IN THEORY AND PRACTICE 58, 58-87 (W. Shepard & T. Gies eds. 1966).

219. *See, e.g.*, WILCOX 476-77.

220 *See* the examples cited in Frankfurter & Hart, *Rate Regulation*, in 13 ENCYC. SOC. SCI. 104, 109 (E Seligman ed. 1934); Beutel, *Due Process in Valuation of Local Utilities*, 13 MINN. L. REV. 409, 423-31 (1929); Rosen, *Comment*, in PERFORMANCE UNDER REGULATION 128, 130 (H. Trebing ed. 1968).

221. Posner, *Natural Monopoly and Its Regulation*, 21 STAN. L. REV. 548, 619 (1969).

results. As utilities have become more complex and expanded their offerings, specific decisions on which services to offer and appropriate rate patterns are those with the greatest impact and importance. For example, a policy conclusion that small ratepayers rather than large should bear the bulk of the costs of a joint plant can have a larger effect on prices than a decision on whether those costs should include a 7 1/2% profit or 8%. Second, there need be no correlation between low profits and the things that should be of concern to the regulators—adequate service, reasonable prices, efficiency and innovation. The simplifying assumption that some correlation exists—on which the popular acceptance of rate base regulation rests—is empirically dubious and theoretically unpersuasive. Finally, there is no longer any reason to fear that a regulated industry will not survive unless it generates enough revenues to attract ample quantities of private capital.[222] This country is accustomed to using government subsidies and even nationalization when necessary for the fulfillment of important social goals.

What is needed is a new formulation of the role of regulation in this society. The decision to regulate a given industry represents a political conclusion that the normal operation of the marketplace must be supplanted to ensure the realization of certain social goals.[223] No one seems to know what those goals are, or what means are most appropriate to reach them. It is time to find out.

222. The influence of this fear over the years cannot be overstated. Even the most perceptive of the writers in this field, James Bonbright, felt in 1928 that regulation was not a substitute for competition, but was instead a necessary means of ensuring the survival of the monopoly public utilities. Bonbright, *The Economic Merits of Original Cost and Reproduction Cost*, 41 HARV. L. REV. 593, 622 (1928).

223. Reich, *The Law of the Planned Society*, 75 YALE L.J. 1227, 1246-47 (1966); J. HILLMAN, COMPETITION AND RAILROAD PRICE DISCRIMINATION xi (1968).