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ADMINISTRATIVE LAW—The Constitutional Limits of the
Power to Regulate: *Duquesne Light Co. v. Barasch*

I. INTRODUCTION

In *Duquesne Light Co. v. Barasch*,¹ the United States Supreme Court clarified the constitutional limits of a state's power to regulate electric utility rates. The case arose when Duquesne Light Company and Pennsylvania Power Company appealed a decision of the Pennsylvania Supreme Court.² In that decision the Pennsylvania court held that under the state's Public Utility Code³ electric utilities were prohibited from recovering costs of cancelled nuclear power plants from ratepayers.⁴ Both utilities charged that the cost exclusion amounted to an unconstitutional "taking" prohibited by the fifth amendment to the United States Constitution.⁵

The Court refused to accept the utilities' analysis, holding instead that there was nothing inherently unconstitutional in a regulatory scheme that prohibited recovery of utility investments that are not "used and useful" in providing service to the public.⁶ It also rejected the utilities' suggestion that they were entitled to a return on all investments that were prudently made.⁷

1. 109 S. Ct. 609 (1989).

2. Under former legislation, the Supreme Court could review by appeal state supreme court decisions that upheld a state statute in the face of a constitutional challenge. 28 U.S.C. § 1257(2) (1982). Congress recently amended the legislation so that the Court may review by writ of certiorari state supreme court decisions that uphold state statutes in the face of constitutional challenges. Act of 27, 1988, Pub. L. No. 100-352, § 3102 Stat. 662 (1988).

3. 66 PA. CONS. STAT. ANN., Tit. 66, § 1315 (Purdon 1979 & Supp. 1989) provides:

Except for such nonrevenue producing, nonexpense reducing investments as may be reasonably shown to be necessary to improve environmental conditions at existing facilities or improve safety at existing facilities or as may be required to convert facilities to the utilization of coal, the cost of construction or expansion of a facility undertaken by a public utility producing, generating, transmitting, distributing or furnishing electricity shall not be made a part of the rate base nor otherwise included in rates charged by the electric utility *until such time as the facility is used and useful in service to the public*. Except as stated in this section, no electric utility property shall be deemed used and useful until it is presently providing actual utility service to the customers. (Emphasis added).

4. *Barasch v. Pa. Pub. Util. Comm'n*, 516 Pa. 142, 149, 532 A.2d 325, 332 (1987).

5. *Id.* at 148, 532 A.2d at 331. The fifth amendment reads in relevant part:

No person shall . . . be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

U.S. CONST. AMEND. V.

6. *Duquesne*, 109 S. Ct. at 618-19.

7. *Id.* at 619-20.

This Note examines the historical rise of the "used and useful" and "prudent investment" regulatory standards. These standards are discussed within the context of the *Duquesne* case, and possible implications for the future of constitutional analysis of regulatory issues are examined.

II. STATEMENT OF THE CASE

In 1973 the Central Power Coordinating Group ("CAPCO"), composed of various utility companies, joined together to construct seven large nuclear power plants.⁸ Both appellants, Duquesne and Penn Power, were members of CAPCO and participated in the construction venture.⁹ After a history of considerable cost overruns and construction delays, the Pennsylvania Public Utility Commission ("PUC") began an investigation of the CAPCO construction program in 1979.¹⁰ Six months after the PUC began its investigation, CAPCO announced its decision to cancel four of the seven power plants.¹¹ CAPCO cited several reasons for the cancellation: growing political and regulatory difficulties following the Three Mile Island accident; worsening financial condition of its members; and a growing awareness that the additional electric capacity would not be needed.¹²

In 1980 and 1981 Duquesne went before the PUC seeking permission to recover the \$34,697,389 it had spent on the abandoned plants.¹³ The PUC delayed a ruling on the request until it received the report from its investigation of CAPCO.¹⁴ The report was issued in late 1982. It declared that neither Duquesne nor Penn Power could be faulted for participating in the power plant construction project.¹⁵ In the words of the report's author, "the CAPCO decisions in regard to the [canceled plants] at every stage to their cancellation, were reasonable and prudent."¹⁶

In 1982 Duquesne came before the PUC again to request an increase in rates to cover the costs of the abandoned plants.¹⁷ During the course of these hearings, the Pennsylvania legislature amended the state's Utility Code, limiting the costs that could be included in electric utility rates.¹⁸ The Utility Code, as amended, prohibits

8. *Id.* at 612.

9. *Id.*

10. *Id.* at 613.

11. *Id.*

12. *Id.*

13. *Id.*

14. *Id.*

15. *Id.*

16. *Id.* (quoting Administrative Law Judge Joseph Matuschak's October 15, 1982 "Report of Investigation," Appendix to Jurisdictional Statement at 19h, *Duquesne Light Co. v. Barasch*, 109 S. Ct. 609 (1989) (No. 87-1160)); see also *Barasch*, 516 Pa. at 144, 532 A.2d at 327.

17. *Duquesne*, 109 S. Ct. at 613.

18. *Id.* at 613-14 (citing 66 PA. STAT. ANN. § 1315 (Purdon 1979 & Supp. 1989)).

the inclusion of the costs of any facility that is not "used and useful in service to the public."¹⁹

In 1983 the PUC issued a final order allowing Duquesne to amortize its losses over a ten year period.²⁰ The Pennsylvania Office of Consumer Advocate ("Consumer Advocate") moved the PUC for reconsideration. The Consumer Advocate argued that these losses were costs within the meaning of the statute and, therefore, not recoverable.²¹ On reconsideration the PUC affirmed the original rate order.²² The PUC interpreted the act which amended the Utility Code to forbid inclusion of the costs of the abandoned plants in the utility's rate base but not their recovery as an operating cost through amortization.²³

The Consumer Advocate then took his case to the commonwealth court where the PUC decisions were upheld.²⁴ The Consumer Advocate appealed this decision to the Pennsylvania Supreme Court, which held that the PUC order violated the amended language of the Utility Code and ordered the PUC to rescind the orders allowing amortization.²⁵ The United States Supreme Court heard arguments in the case on November 7, 1988, and handed down its decision on January 11, 1989.²⁶

19. *Id.* at 614.

20. *Id.* Amortization is an accounting practice whereby businesses recover the costs associated with their intangible property such as patents, copyrights, trademarks, business goodwill, etc. It is comparable to the depreciation of tangible assets. The major difference is that the deterioration of tangible property can be observed while intangible property devalues according to its useful legal life. In the present case, an amortization period of 10 years was selected as a reasonable figure by regulators. Amortization is generally figured at an equal amount for each year and is regarded as an operating expense rather than as an asset. See A. SHUGERMAN, ACCOUNTING FOR LAWYERS 297-98 (1952).

21. *Duquesne*, 109 S. Ct. at 613-14.

22. *Id.* at 614.

23. *Barasch*, 516 Pa. at 145, 532 A.2d at 328. The court stated, "Regarding the express dictate in section 1315 that such costs 'shall not be made part of the rate base *nor otherwise included in rates charged*,' the Commission opined that the foregoing statutory language was intended solely to prevent the regulatory agency from giving a utility dual benefits of the costs, *i.e.*, including the costs in the rate base *and* in some other rate making process.

Id. at 145-46, 532 A.2d at 328-29 (emphasis added by the court).

24. *Duquesne*, 109 S. Ct. at 614.

25. *Barasch*, 516 Pa. at 156, 532 A.2d at 339. The court stated, "We . . . hold that section 1315 of the [Utility] Code must be read as prohibiting an electric utility from recovering the costs of cancelled plants from ratepayers, either by making such costs part of its rate base or by converting them into operating expenses through amortization. For us to reach any other conclusion, we would have to treat as surplusage that part of section 1315's proscription which says ' . . . nor otherwise included in the rates charged by the electric utility.'"

Id. at 129, 532 A.2d at 332.

26. *Duquesne*, 109 S. Ct at 609.

III. HISTORICAL BACKGROUND

As noted by the Court in *Duquesne*, utility rate-making proceedings do not, as a rule, involve issues of constitutional magnitude.²⁷ The well-publicized failures of nuclear power projects have, however, destabilized the public utility industry and prompted a re-examination of the constitutional limits of state utility regulation.²⁸ These failures have tended to take three forms: the plants have come on line but at prices far in excess of original expectations; the plants have been completed but the capacity has been unneeded or "excess"; or the plants have been abandoned before completion.²⁹ To grasp the reasons behind this massive, industry-wide miscalculation, it is first necessary to examine the roots of the crisis.

The period from the end of World War II to the late 1960's had seen the demand for electricity increase by seven percent per year.³⁰ This historical demand was expected to hold true for the foreseeable future.³¹ As a result, the typical utility of the late 1960's and early 1970's believed that it would have to provide almost twice as much electricity to the public by the 1980's.³² In order to keep pace with this growth in demand, many utility companies turned to nuclear power as an answer to the projected increase in demand.³³ Today, with the cancellation of literally scores of these nuclear projects, these decisions seem particularly ill-considered. However, the utility planners of that earlier period had sound economic and environmental reasons for choosing the nuclear option.

Most forecasters of the period had predicted that upon completion nuclear power plants would be competitive with gas and coal fired generation.³⁴ The oil embargo of 1973, which sent oil prices soaring by as much as 180 percent during subsequent years, seemed to confirm these predictions.³⁵ This same crisis seemed to place the

27. *Id.* at 617.

28. See generally Gioia, *The Prudence Standard: Recent Experience and Future Relevance*, PUB. UTIL. FORT., April 27, 1989, at 11.

29. Pierce, *The Regulatory Treatment of Mistakes in Retrospect: Canceled Plants and Excess Capacity*, 132 U. PA. L. REV. 497, 498-500 (1984).

Over one hundred nuclear units have been canceled, and many other such units are only now nearing completion. Investments of approximately ten billion dollars have already been lost as a result of nuclear plant cancellations, and future cancellations are expected to involve additional sunk costs of five to eight billion dollars. In addition, many of the recently completed or soon-to-be completed plants represent scores of billions of dollars wasted on what now appears to be totally superfluous generating capacity.

Id. at 498-99.

30. Kaufman, *Commission Treatment of Overcapacity*, National Regulatory Research Institute, No. 84-10, 16 (September 1984).

31. Pierce, *supra* note 29, at 500.

32. Kaufman, *supra* note 30, at 130.

33. *Id.*

34. Pierce, *supra* note 29, at 502.

35. Kaufman, *supra* note 30, at 132.

uninterrupted supply of oil and gas in great jeopardy.³⁶ Government officials began to emphasize "energy independence" for the United States and actively encouraged the switch to nuclear generation.³⁷ The government also made it clear that for environmental reasons it preferred nuclear to coal-fired generation.³⁸ Dramatic rises in the cost of coal during the recession of 1974-75 drove utilities to further reliance on the promises of nuclear energy.³⁹

During the decade of the early 1970's to the 1980's, the projected seven percent growth in demand did not materialize. Actual growth took place at the more modest rate of three percent.⁴⁰ Slower than expected economic growth during the decade, drops in electric consumption due to price increases and more efficient use, steep declines in the cost of both oil and natural gas, dramatic rises in the cost of industrial capital, and increased political and regulatory antipathy toward nuclear generation all combined to place the electric generation industry in a historically unique and quite unexpected crisis.⁴¹

Across the nation, utility companies with nuclear power plants under construction or ready to come on line found themselves in a double predicament. The nuclear facilities were not needed as the utilities were already awash in "excess capacity" and the cost of new power from nuclear plants was often five to six times the cost of power generated by other fuels.⁴² Faced with this no-win situation, many utilities decided that the better part of valor was simply to cancel their unfinished nuclear projects and cut their losses.⁴³ This was the alternative chosen by the utilities in *Duquesne*.⁴⁴

36. Pierce, *supra* note 29, at 501.

37. As late as 1978 Congress instituted legislation that prohibited the use of "natural gas or petroleum as a primary energy source in any new electric powerplant" built after November of that year. Powerplant and Industrial Fuel Use Act of 1978, 42 U.S.C. § 8311 (1982), *see* Pierce, *supra* note 29, at 502 n.23.

38. Kaufman, *supra* note 30, at 134-35.

39. The price for a ton of coal jumped from \$8.42 at the beginning of 1974 to an average of \$19.25 at the end of 1975. At one point during those years, the spot-market price of coal was as high as \$40 per ton. These statistics are reported in Kaufman, *supra* note 30, at 133.

40. Pierce, *supra* note 29, at 502.

41. *Id.* at 503-05.

42. *See* Miss. Power & Light Co. v. Miss., 108 S. Ct. 2428 (1988). The problems Duquesne Power experienced with its nuclear plants are remarkably similar to those of many other utilities. The following passage details the experience of Middle South Utilities with its Grand Gulf nuclear project.

It was originally estimated that the cost per kilowatt of capacity would be about \$500; by the time commercial operations began, that cost amounted to \$2,933. The original estimate for the cost of two nuclear units at Port Gibson was approximately \$1.2 billion. Regulatory delays, additional construction requirements imposed after the Three Mile Island disaster, and severe inflation, however, ran up Grand Gulf costs to more than \$3 billion dollars for the single unit.

Id. at 2432 n.5.

43. Pierce, *supra* note 29, at 497-98.

44. *Duquesne*, 109 S. Ct. at 612-13.

IV. ANALYSIS AND DISCUSSION

A. *The Historical Rise of Constitutional Regulatory Criteria*

In 1877 the Supreme Court made its first foray into the area of regulatory law in *Munn v. Illinois*.⁴⁵ In *Munn* the Court explored the state of Illinois' power under the Constitution to regulate private grain elevators. It found the Illinois state legislature could regulate these grain elevators because they were businesses "affected with the public interest."⁴⁶ The Court rejected the notion, however, that the courts should review the actions of a state legislature. The Court stated that "the people must resort to the polls, not to the courts" to find relief from unreasonable rates.⁴⁷

As the Court continued to deal with the regulation of businesses such as grain elevators, toll roads, water utilities, and railroads, it began to better understand the unique nature of these enterprises. These businesses are unusual in that they were privately owned but their assets were dedicated to the public use.⁴⁸ As the *Duquesne* Court noted, this "partly public, partly private status of utility property creates its own set of questions under the Takings Clause of the Fifth Amendment."⁴⁹

Nine years after the *Munn* decision, the Court, in the *Railroad Commission Cases*,⁵⁰ first began to explore its role in answering these fifth amendment questions.

This power to regulate is not a power to destroy. . . . Under the pretense of regulating fares and freights, the state cannot require a railroad corporation to carry persons or property without reward; neither can it do that which in law amounts to a taking of private property for public use without just compensation, or without due process of law.⁵¹

45. 94 U.S. 113 (1877).

46. *Id.* at 126. Although the Court did not define this somewhat ambiguous phrase, it seemed to be concerned mainly about the monopolistic character of these grain elevator companies.

[A]lthough in 1874 there were in Chicago fourteen warehouses adapted to this particular business, and owned by about thirty persons, *nine business firms controlled them, and that the prices charged and received for storage were such "as have been from year to year agreed upon and established by the different elevators"* . . . Thus it is apparent that all the elevating facilities through which these vast productions "of seven or eight great States of the West" must pass on the way "to four or five of the States on the seashore" may be a "virtual" monopoly.

Id. at 131 (emphasis added).

47. *Id.* at 134.

48. *Duquesne*, 109 S. Ct. at 615.

49. *Id.*

50. 116 U.S. 307 (1886).

51. *Id.* at 331.

Railroad Commission, thus, established the general principle that regulation could be confiscatory if carried too far.⁵² The Court left the determination of where to draw this line, however, to subsequent decisions. In order to appreciate the practical difficulties the Court faces when determining whether a rate is confiscatory, it is first necessary to understand both the rationale behind utility regulation and the elements of the typical rate-making procedure.

B. The Need for Regulation

The need for government regulation in the electric utility industry has traditionally been premised on the notion that these utilities are "natural monopolies."⁵³ To an economist a monopoly is a natural one if it is created by forces over which the monopolist has no control;⁵⁴ its creation may be unrelated to the number of sellers in the marketplace:

The term does not refer to the actual number of sellers in a market but to the relationship between demand and the technology of supply. If the entire demand within a relevant market can be satisfied at lowest cost by one firm rather than by two or more, the market is a natural monopoly, whatever the actual number of firms in it.⁵⁵

Economists have isolated several factors which have driven the electric utilities into monopolistic domination of their market areas. First, electric power can only be transported efficiently over limited distances. This limitation effectively defines the market area for a particular utility plant. It also reduces the number of utility companies that can profitably operate within that limited market area.⁵⁶ Second, the high initial cost of starting a facility for electric generation discourages newcomers from getting into the market.⁵⁷ Third, utility plants historically have been able to produce power more cheaply as they have grown larger. This phenomenon is known as economies of scale.⁵⁸ The combined force of these three factors has inexorably reduced most electric utility markets to a single large provider.⁵⁹ The

52. *Id.* For a complete discussion of the relation between utility regulation and the takings clause, see Drobak, *From Turnpike to Nuclear Power: The Constitutional Limits on Utility Rate Regulation*, 65 B.U.L. REV. 65 (1985) and Pond, *The Law Governing the Fixing of Public Utility Rates: A Response to Recent Judicial and Academic Misconceptions*, 41 ADMIN. L. REV. 1 (1989).

53. Posner, *Natural Monopoly and Its Regulation*, 21 STAN. L. REV. 548 (1969). It is not my purpose here to do more than give a simplified description of these concepts as a background to the discussion of the issues in *Duquesne*.

54. Black's Law Dictionary 908 (5th ed. 1979).

55. Posner, *supra* note 53, at 548.

56. J. BONBRIGHT, *PRINCIPLES OF PUBLIC UTILITY RATES* 11-17 (1961).

57. *See id.*

58. *Id.*

59. Posner, *supra* note 53, at 612.

prospects for success of a new provider in the same market become minimal:

If [another firm] enters in the mistaken belief that the market will support more than one seller or that it is more efficient than the incumbent, it will soon be eliminated either by bankruptcy or by being acquired (presumably at a low price, reflecting its poor prospects) by the incumbent.⁶⁰

States have been justifiably fearful of the power of the monopolistic utility companies to take unfair advantage of their position of dominance in the market. In response, state governments have established regulatory bodies to curb the potential for abuse.⁶¹

C. The Rate-Making Procedure

When setting utility rates, the regulator must balance the utility's need for adequate revenues against the consumer's need for reasonable rates.⁶² In order to accomplish this balancing, the regulator must make three initial determinations: (1) the utility's operating and maintenance costs; (2) its rate base; and, (3) its rate of return.⁶³ In the first determination, the regulator ascertains whether the utility's operation and maintenance costs are in line with similar costs in other sectors of the industrial economy.⁶⁴ As part of this oversight, the regulator will usually require the utility to adhere to standardized

60. *Id.*

61. Brief for the National Association of State Utility Consumer Advocates ("NASUCA") as amicus curiae at 6-8, *Duquesne Light Co. v. Barasch*, 109 S. Ct. 609 (1989) (No. 87-1160).

History shows that as the electric industry developed in this country individual state legislatures gradually determined that electric companies were natural monopolies and that it was in society's interest to grant them monopoly status. . . .

In this context legislators disregarded one of the basic premises of a free enterprise system: that free competition resulted in the best allocation of society's resources and resulted in a fair price for an adequate output of goods. . . . The regulator has the difficult and complex role of determining rates that are just and reasonable from both the captive ratepayer and investor perspectives.

62. New Mexico's Public Utility Act is a classic statement of the dual ends of a state regulatory body:

It is the declared policy of the state that the public interest, the interest of consumers and the interest of investors require the regulation and supervision of such public utilities to the end that reasonable and proper services shall be available at fair, just and reasonable rates, and to the end that capital and investment may be encouraged and attracted so as to provide for the construction, development and extension, without unnecessary duplication and economic waste, of proper plants and facilities for the rendition of service to the general public and to industry.

N.M. STAT. ANN. § 62-3-1(B) (Repl. Pamp. 1984).

63. See, KAHN, *THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS* 26-57 (1970).

64. *Id.* at 26-27.

accounting practices so that comparisons can be made with reasonable accuracy.⁶⁵

In the second determination, the rate base, the regulator places a value on the utility's assets. For the typical electric utility, the rate base will primarily include its investment in major items of equipment: its power plants and transmission lines.⁶⁶ Rate base will also generally include support facilities, real estate holdings such as utility easements or office buildings, and other assets the utility uses to provide service to its customers.⁶⁷ As in *Duquesne*, the regulator may also be called upon to determine if investments in a failed or non-useful facility may be included in the rate base.⁶⁸

In the third determination, the regulator sets an adequate rate of return for the utility investors.⁶⁹ Conceptually, this is a simple process.⁷⁰ An adequate rate will be one that allows the utility to attract and hold the equity capital necessary to provide service.⁷¹ As the *Duquesne* Court noted,

[a] public utility is entitled to such rates as will permit it to earn a return . . . equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties.⁷²

The regulator then combines these three figures using a rate-making formula. The most commonly used formula is as follows:

Revenue Requirement = Operating Cost + (Rate Base x Rate of Return).⁷³

Since public utilities are unusually capital-intensive, the rate base figure is typically the largest sum in the rate-making equation. By virtue of its very size, the rate base tends to become the focus of controversy.⁷⁴ Since both the cost of electricity and the utility com-

65. *Id.* at 26.

66. *Id.* at 35-36.

67. *Id.* at 35-37.

68. *Duquesne*, 109 S. Ct. at 618.

69. KAHN, *supra* note 63, at 42-43.

70. Posner, *supra* note 53, at 594. Though conceptually simple, the actual determination of an adequate or fair rate of return is often extremely difficult.

In deciding what the cost [of equity] is, however, the parties to the regulatory proceeding and the commission itself are thrown back on very rough comparisons with other firms and other industries. Frequently these comparisons are circular because they are to other regulated firms. When they are not circular, they are misleading because they compare a regulated firm with firms that are not monopolists and that are engaged in dissimilar business.

Id.

71. *Id.*

72. *Duquesne*, 109 S. Ct. at 619 (quoting *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm'n of W. Va.*, 262 U.S. 679, 692-93 (1923)).

73. L. SCHWARTZ, *FREE ENTERPRISE AND ECONOMIC ORGANIZATION: GOVERNMENT REGULATION* 326 (6th ed. 1985).

74. KAHN, *supra* note 63, at 36.

pany's profits are to a large degree dependent on the size of the rate base figure, it is not surprising that determination of the rate base has historically been the most fiercely contested regulatory issue.⁷⁵ The present case is, at its simplest, merely a re-emergence of this classic conflict.⁷⁶

D. Constitutional Standards for Rate Base Valuations

Over the years two distinct approaches to rate base valuation have emerged.⁷⁷ These differing approaches have various names according to the way in which they are applied in a particular case. The first approach is most widely known as the "fair value rule."⁷⁸ Under this rule, the regulator must appraise the utility's rate base (assets) at its present day value or the cost to reproduce it in today's market.⁷⁹ Typically under this fair value approach only those assets actually used and useful in providing service are included in the final rate base figure.⁸⁰ The second approach is called the "prudent investment rule."⁸¹ Generally speaking, under this rule the assets are valued at the amount of capital prudently invested in them, or their actual historical cost.⁸² All prudently invested amounts are then included in the rate base regardless of whether they are currently used and useful.⁸³

1. The Fair Value/Used and Useful Rule

The fair value rule can be traced to the Court's decision in *Smyth v. Ames*.⁸⁴ The *Smyth* Court held 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*."⁸⁵

In *Willcox v. Consolidated Gas Co.*⁸⁶ the Court amplified the *Smyth* rule when it held that

[t]here must be a *fair return* upon the reasonable value of the property *at the time it is being used for the public*. . . . [T]he value of the property is to be determined *as of the time when the inquiry is made regarding rates*. If the property, which legally

75. *Id.*

76. *Duquesne*, 109 S.Ct. at 613-14.

77. *Id.* at 616.

78. *Id.*

79. *Id.*

80. *Id.*

81. *Id.*

82. *Id.*

83. *Id.*

84. 169 U.S. 466 (1898).

85. *Id.* at 546 (emphasis added).

86. 212 U.S. 19 (1909).

enters into the consideration of the question of rates, has increased in value since it was acquired, the company is entitled to the benefit of such increase.⁸⁷

As noted above, the fair value rule includes two related concepts: "used and useful" and "present or reproduction value." The logic combining these concepts was cogently explained by the *Duquesne* court as follows:

In theory the *Smyth v. Ames* fair value standard mimics the operation of the competitive market. To the extent utilities' investments in plants are good ones (because their benefits exceed their costs) they are rewarded with an opportunity to earn an "above-cost" return, that is a fair return on the current "market value" of the plant. To the extent utilities' investments turn out to be bad ones (such as plants that are canceled and so never used and useful to the public), the utilities suffer because the investments have no fair value and so justify no return.⁸⁸

The fair value rule, though persuasive in theory, was difficult to implement.⁸⁹ It required utility commissions to constantly reappraise the value of utility property. Since "the current value of property was necessarily a matter of judgment . . . every commission decision was subject to dispute and litigation."⁹⁰

2. The Prudent Investment-Historical Cost Approach

As an alternative to the fair value approach, Justice Brandeis proposed the prudent investment rule in his concurring opinion in *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission*.⁹¹ Justice Brandeis believed that the Constitution required that the utility be allowed to earn "a fair return on the amount prudently invested in it."⁹² Under this rubric, "the utility is compensated for all prudent investments at their actual cost when made (their 'historical' cost), irrespective of whether individual investments are deemed necessary or beneficial in hindsight."⁹³

Justice Brandeis found the fair value approach "legally and economically unsound."⁹⁴ He argued that

[t]he rule of *Smyth v. Ames* sets the laborious and baffling task of finding the *present value* of the utility. It is impossible to

87. *Id.* at 41 (emphasis added).

88. *Duquesne*, 109 S. Ct. at 616; see also *Pierce*, *supra* note 29, at 525.

89. *Gioia*, *supra* note 27, at 12.

90. *Id.*

91. 262 U.S. 276, 310 (1923).

92. *Id.* at 289.

93. *Duquesne*, 109 S. Ct. at 616. "Every investment may be assumed to have been made in the exercise of reasonable judgment, unless the contrary is shown." *Mo. ex rel. S.W. Bell Tel. Co.*, 262 U.S. at 289 n.1.

94. *Mo. ex rel. S.W. Bell Tel. Co.*, 262 U.S. at 290.

find an exchange value for a utility, since utilities, unlike merchandise or land, are not commonly bought and sold on the market. Nor can the present value of the utility be determined by capitalizing its net earnings, since earnings are determined, in large measure, by the rate which the company will be permitted to charge; and, thus, the vicious circle will be encountered.⁹⁵

"The thing," Justice Brandeis noted, "devoted by the investor to the public use is not *specific property*, tangible and intangible, but *capital* embarked in the enterprise."⁹⁶ Under this approach, the rate base valuation would remain stable and not vary up or down depending on the current economic trend.⁹⁷ Moreover, the approach would remove the subjectivity of appraisals and provide a factual foundation for rate base valuations.⁹⁸

As Justice Rehnquist noted in the *Duquesne* decision, the Brandeis prudent investment formula avoids

the difficult valuation problems encountered under the *Smyth v. Ames* test because it relies on the *actual historical cost* of investments as the basis for setting the rate. The amount of a utility's actual outlays for assets in the public service is more easily ascertained by a rate-making body because less judgment is required than in valuing an asset.⁹⁹

The Brandeis formula further simplified the regulatory process because there was the presumption of prudence on the part of the utility investor.¹⁰⁰

Brandeis saw the stability and simplicity of the prudent investment approach as rendering benefits both to the investor and the consumer.

95. *Id.* at 292 (emphasis added).

96. *Id.* at 290 (emphasis added).

97. Gioia, *supra* note 28, at 12.

98. The Court in *Missouri. ex rel. Southwestern Bell Telephone Co.* explained: The adoption of the amount prudently invested as the rate base and the amount of the capital charge as the measure of the rate of return would give definiteness to these two factors involved in rate controversies which are now shifting, and treacherous and which render the [regulatory] proceedings peculiarly burdensome and largely futile. . . . The rate base would be ascertained as a fact, not determined as a matter of opinion. . . . It would not be distorted by the fickle and varying judgments of appraisers, commissions, or courts. It would, when once made in respect to any utility, be fixed, for all time, subject only to increases to represent additions to plant, after allowance for the depreciation included in the annual operating charges.

262 U.S. at 306-07.

99. *Duquesne*, 109 S. Ct. at 617 n.6 (emphasis added).

100. *Mo. ex rel. S.W. Bell Tel. Co.*, 262 U.S. at 289 n.1. The Court states, The term prudent investment is not used in the critical sense. There should not be excluded from the finding of the [rate] base, investments which, under ordinary circumstances, would be deemed reasonable. The term is applied for the purpose of excluding what might be found to be dishonest or obviously wasteful or imprudent expenditures.

Id.

The investor could count on a predictable and steady return on his investment. The consumer could be freed of the high cost of capital associated with the speculative investment environment under the fair value rule.¹⁰¹

3. The End-Result Test

Despite the attractiveness of the prudent investment/historical cost approach and its acceptance by many commentators and courts, the fair value rule remained the constitutionally required standard until 1944.¹⁰² It was not officially abandoned by the Court until *Federal Power Commission v. Hope Natural Gas Co.*,¹⁰³ The *Hope* Court held that the Constitution mandated no single rate-making formula. Rather, it merely required that fair, nonconfiscatory rates be the *end result* of the rate making process.

It is not the *theory* but the *impact* of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act [the Natural Gas Act of 1938, 15 U.S.C. Section 717] is at an end. The fact that the method employed to reach that result may contain infirmities is not then important. Moreover, the Commission's order does not become suspect by reason of the fact that it is challenged. It is the product of expert judgment which carries a presumption of validity.¹⁰⁴

At issue in *Hope* was the validity of rates set by the Federal Power Commission ("FPC").¹⁰⁵ Under the Natural Gas Act of 1938 (the "Act"), the FPC was given the authority to set interstate natural gas rates at levels that were "just and reasonable."¹⁰⁶ Congress, however, provided no formula in the Act by which such rates could be determined.¹⁰⁷

The case began when the complaints were filed with the FPC, charging that Hope's interstate rates were excessive.¹⁰⁸ After an investigation, the FPC ordered Hope to reduce its interstate rates.¹⁰⁹ The FPC's decision was based, in part, on a finding that Hope had overvalued its rate base when it used reproduction cost (the fair value method) in its valuation.¹¹⁰ The FPC refused to place any reliance on Hope's reproduction cost formula saying that "it was

101. *Id.* at 304-08.

102. Drobak, *supra* note 52, at 83-84.

103. 320 U.S. 591 (1944).

104. *Id.* at 602 (emphasis added).

105. *Id.* at 593.

106. *Id.* at 600.

107. *Id.*

108. *Id.* at 594.

109. *Id.* at 595.

110. *Id.* at 596-97.

not predicated upon facts and was too conjectural and illusory to be given any weight"¹¹¹ Instead, the FPC opted for a rate base figure that reflected Hope's actual historical investment.¹¹² On review, the court of appeals set aside the FPC mandated rate reduction.¹¹³ The Court held that the FPC, in determining the value of the rate base, "should have considered reproduction cost . . . and that 'actual legitimate cost' (prudent investment) was not the proper measure of 'fair value' where price levels had changed since the investment."¹¹⁴ By affirming the constitutionality of the FPC rates, the Court implicitly accepted the validity of the historical cost/prudent investment approach. It necessarily rejected the notion that the fair value/used and useful approach was the only constitutionally acceptable rate methodology.¹¹⁵

The wisdom of the *Hope* end-result test was that it did not tie constitutional analysis to a single rate-making theory. Its weakness was in its lack of specificity. The Court never delineated an exact test by which the fairness of the end result could be measured. Rather it opted for a regimen of "pragmatic adjustments."¹¹⁶ As a broad rule it stated that "[t]he rate-making process under the Act, i.e., the fixing of 'just and reasonable' rates, involves a *balancing of the investor and the consumer interests*."¹¹⁷ In describing the investor side of the scale, the *Hope* Court stated:

[I]t 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.¹¹⁸

On the consumer side, the *Hope* Court noted that the primary aim of the regulation under review was "to protect consumers against exploitation at the hands of natural gas companies."¹¹⁹ It also noted that "regulation does not insure that the business shall produce net revenues."¹²⁰ Beyond these broad outlines, the Court did not venture.

111. *Id.* at 597.

112. *Id.* at 596.

113. *Id.* at 599.

114. *Id.* at 600.

115. *Id.* at 602.

116. *Id.*

117. *Id.* at 603 (emphasis added).

118. *Id.* (citations omitted).

119. *Id.* at 611.

120. *Id.* at 603 (quoting *Federal Power Comm'n v. Natural Gas Pipeline Co.*, 315 U.S. 575, 590 (1942)).

By allowing any rate making standard which would produce a reasonable result, the Court accepted the limits of its own authority. It recognized that the FPC's rate-setting activities were well within Congress' power "to regulate the prices of commodities in interstate commerce."¹²¹ Under the Constitution, then, the Court could not substitute its "opinions for the expert judgment of the administrators to whom Congress entrusted the [rate-making] decision."¹²² The Court's duty was the more circumscribed one of ensuring that the final rate would not be "unjust and unreasonable in its consequences."¹²³

Because the *Hope* decision did not provide firm guidance, controversy over the valuation of the rate base has continued to rage.¹²⁴ Two factors have combined to keep this controversy alive: the conflicting policy considerations embodied in the competing regulatory standards and the divergent economic interests of the utility investors and the ratepayers.¹²⁵

The policy behind the fair value rule is to make regulation mimic the competitive marketplace.¹²⁶

A competitive market does not forgive mistakes in forecasting demand or in projecting the costs of alternative means of providing service, however understandable those mistakes may be. . . . In a competitive market, firms operating with excess capacity do not earn a return on that capacity. Nor do firms that cancel partially completed plants because of unanticipated shortfalls in demand recover their investments in the plants.¹²⁷

The policy behind the prudent investment rule, on the other hand, is to bring certainty and stability to the regulated industry.¹²⁸ Brandeis saw controversy and uncertainty as destructive forces.

Controversy with utilities is obviously injurious also to the public interest. The prime needs of the community are that facilities be ample and that rates be as low and as stable as possible. The community can get cheap service from private companies, only through cheap capital. It can get efficient service, only if

121. *Id.* at 601 (quoting *Natural Gas*, 315 U.S. at 582).

122. *Id.* at 615.

123. *Id.* at 602.

124. Drobak, *supra* note 52, at 112-25.

125. *Id.*

126. *Duquesne*, 109 S.Ct. at 616.

127. *Pierce*, *supra* note 29, at 525.

128. The Court in *Missouri ex rel. Southwestern Bell Telephone Co.* stated:

To give to capital embarked in public utilities the protection guaranteed by the Constitution, and to secure for the public reasonable rates, it is essential that the rate base be definite, stable, and readily ascertainable; and that the percentage to be earned on the rate base be measured by the cost, or charge, of the capital employed in the enterprise.

Mo. ex rel. S.W. Bell Tel. Co., 262 U.S. at 292.

managers of the utility are free to devote themselves to problems of operation and of development. It can get ample service through private companies, only if investors may be assured of receiving continuously a fair return upon the investment.¹²⁹

The competing economic interests of the consumer and the investor have also kept the debate over regulatory standards alive. The fair value rule was first championed by ratepayers during a time of unparalleled deflation.¹³⁰ These ratepayers were unwilling to pay a high cost for a regulated service when the cost of everything else had fallen dramatically.¹³¹

Utilities and their investors, on the other hand, have championed the fair value approach during times of escalating prices, hoping to profit from the inflated value of the rate base.¹³² Faced with the devaluation of the utility's property, however, the investor seeks the protection of the prudent investment approach.¹³³

In *Hope* the Court clearly removed itself from the role of refereeing rate squabbles and adopted a role of general oversight.¹³⁴ Having found that the end result of the rate was fair to both investors and consumers, it left further delineation of fairness under the end result approach to subsequent courts.¹³⁵

E. The Duquesne Decision

The *Duquesne* Court unequivocally accepted the *Hope* end result test.¹³⁶ By so doing, the Court again refused to place itself in the midst of every investor/consumer controversy.¹³⁷ It stated that these controversies had constitutional implications "at the margins."¹³⁸ "The economic judgments required in rate proceedings are often

129. *Id.* at 308.

130. *See id.* at 287, 298; *see also, Hope* 320 U.S. at 596-97; *Bluefield Waterworks*, 262 U.S. at 684.

Reproduction cost, as the measure, or as evidence, of present value was, also, pressed then by representatives of the public who sought to justify legislative reductions of railroad rates. The long depression which followed the panic of 1893 had brought prices to the lowest level reached in the Nineteenth Century. Insistence upon reproduction cost was the shippers's protest against burdens believed to have resulted from watered stocks, reckless financing, and unconscionable construction contracts.

Mo. ex rel. S.W. Bell Tel. Co., 262 U.S. at 298.

131. *Mo. ex rel. S.W. Bell Tel. Co.*, 262 U.S. at 298.

132. *Hope*, 320 U.S. at 596.

133. *Duquesne*, 109 S. Ct. at 619-20 (*Duquesne* urged the Court to approve the prudent investment rule as a required constitutional rate-making standard); *Market Street Railway Co. v. Pub. Serv. Comm'n of Wis.*, 324 U.S. 548, 567 (1945).

134. *Hope*, 320 U.S. at 601 ("'[F]air value' is the end product of the process of ratemaking not the starting point . . .").

135. *Id.* at 605.

136. *Duquesne*, 109 S.Ct. at 616 n.5.

137. *Id.*

138. *Id.*

hopelessly complex and do not admit of a single correct result. *The Constitution is not designed to arbitrate these economic niceties.*"¹³⁹

The *Duquesne* Court began its analysis by recognizing that both utility companies had a duty, under the state's Utility Code, to serve the public.¹⁴⁰ The state had a corresponding constitutional duty to set rates at "higher than a confiscatory level."¹⁴¹ "If the rate does not afford sufficient compensation," the Court noted, "the State has taken the use of utility property without paying just compensation and so violated the Fifth and Fourteenth Amendments."¹⁴² The Court admitted, however, that "[n]either law nor economics has yet devised generally accepted standards" to guarantee non-confiscatory rates.¹⁴³

The Court then noted that in the present case, as in *Hope*, the utilities had not alleged that the challenged rates put them in financial difficulties.¹⁴⁴ For example, the 35 million dollars *Duquesne* had invested in the canceled nuclear plants comprised only 1.9 percent of its rate base.¹⁴⁵ The decision to disallow recovery of these costs only reduced *Duquesne's* and Penn Power's annual revenue allowances by approximately 0.5 percent for each utility.¹⁴⁶ The Court found that:

[t]he overall impact of the rate orders, then, is not constitutionally objectionable. No argument has been made that these slightly reduced rates jeopardize the financial integrity of the companies, either by leaving them insufficient operating capital or by impeding their ability to raise future capital. Nor has it been demonstrated that these rates are inadequate to compensate current equity holders for the risk associated with their investments under a modified prudent investment scheme.¹⁴⁷

The utilities argued, however, that the Utility Code, as amended by section 1315 was unconstitutional because it combined two inconsistent regulatory standards.¹⁴⁸ According to the utilities, the Code required the Commission to produce the lowest possible rates by shifting between the prudent investment and market value approaches.¹⁴⁹

139. *Id.* at 619 (emphasis added).

140. *Id.* at 615.

141. *Id.* at 616 (quoting *FPC v. Texaco Inc.*, 417 U.S. 380, 391-92 (1974)).

142. *Duquesne*, 109 S. Ct. at 616.

143. *Id.* (quoting *Permain Basin Area Rate Cases*, 390 U.S. 747, 790 (1968)).

144. *Duquesne*, 109 S. Ct. at 618; see also *Hope*, 320 U.S. at 605.

145. *Duquesne*, 109 S. Ct. at 618.

146. *Id.*

147. *Id.*

148. *Id.* at 617 n.7.

149. The appellants, in their reply brief submitted to the *Duquesne* Court, argued: Pennsylvania's methodology is unacceptable because it requires the Pennsylvania Utility Commission to shift between prudent investment and market value regulatory methods as needed to produce the lowest possible rate. If

The *Duquesne* Court specifically stated that if Pennsylvania had arbitrarily switched back and forth between rate methodologies "in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others," a serious constitutional question would be raised.¹⁵⁰ The Court ruled, however, that the end result of the state's mingling of regulatory standards under section 1315 had not been unreasonable.¹⁵¹ Therefore, the challenged amendments to the Utility Code did not amount to an impermissible vacillation between methodologies.¹⁵²

Finally, the Court expressly refused to make the prudent investment/historical cost methodology a constitutional standard. The Court held that "[t]he designation of a single theory of rate making as a constitutional requirement would unnecessarily foreclose alternatives which could benefit both consumers and investors."¹⁵³

V. IMPLICATIONS OF *DUQUESNE*

The importance of *Duquesne* is in its reaffirmation of the *Hope* end-result approach to rate regulation. It clearly held that a rate is never automatically confiscatory simply because it disallows some utility costs under a particular rate-making formula.¹⁵⁴ However, like *Hope*, *Duquesne* did not indicate how much cost disallowance might be too much. Though *Duquesne* mentioned the utility's interest in maintaining its financial integrity as a factor in setting rates,¹⁵⁵ the Court did not clearly indicate where the line between fair and confiscatory rates should be drawn. The *Duquesne* Court refused to address this issue since neither of the utilities before it alleged any serious financial harm.¹⁵⁶

utility operations have successfully matched available electrical generating capacity and actual consumer demand for electricity, whether due to beneficial circumstances or to efficient management, Pennsylvania applies the prudent investment utility methodology. Under this approach, investors in the utility are restricted to a return *of* and a modest return *on* the historical value of their original investment. On the other hand, if utility management prudently expends funds to prepare for reasonably anticipated future growth, but that growth does not materialize, Act 335 [section 1315] is applied. Suddenly the State looks not at the amount of the original prudent investment but rather to the market value of the items or services purchased. Regardless of how prudent an investment may have been when made, it is conclusively presumed to have no value and on that basis the statute bars the utility from retrieving any part of its investment.

Reply Brief for Appellants at 8, *Duquesne Light Co. v. Barasch*, 109 S. Ct. 609 (1989) (No. 87-1160) (emphasis in original).

150. *Duquesne*, 109 S. Ct. at 619.

151. *Id.* at 617-18.

152. *Id.* at 619.

153. *Id.* at 620.

154. *Id.* at 615-20.

155. *Id.* at 617, 618.

156. *Id.* at 620.

A possible indication of the Court's post-*Duquesne* direction may be inferred from its subsequent handling of *In re Public Service Co. of New Hampshire*.¹⁵⁷ On January 28, 1988, the Public Service Company of New Hampshire ("PSNH") became the first public utility company since the Depression era to file for bankruptcy.¹⁵⁸ The utility was denied recovery of investments in a non-useful nuclear power plant under an amendment to New Hampshire's utility statute similar to that at issue in *Duquesne*.¹⁵⁹ Unlike the utilities in *Duquesne*, the rate decision had a significant adverse effect on PSNH.¹⁶⁰ Despite the utility's financial difficulty, the Supreme Court dismissed an appeal from the New Hampshire Supreme Court "for want of a properly presented federal question."¹⁶¹ The apparent conclusion to be drawn from this action is that nothing in the *Duquesne* decision requires regulators to automatically guarantee the financial health of a public utility company.

At least one commentator has concluded that the Court made a mistake by choosing not to hear the *New Hampshire* case.¹⁶²

The Court need not have reviewed the *Duquesne* case; it simply told us what we already knew: That a state legislature can enact laws governing utility rate making . . . if they invoke a coherent policy based upon reasoned analysis, and are not arbitrary or capricious.

But the appeal of the Public Service Company of New Hampshire posed a question that the Court left unanswered: Must regulators bow to a valid law or policy and deny cost recovery for canceled plant, *even if compliance leads inexorably to a final rate award that is confiscatory and thus unlawful of its own accord*.¹⁶³

Perhaps this commentator is ignoring the answer implicit in the Brandeis prudent investment test. "The term [prudent investment] is applied for the purpose of *excluding* what might be found to be dishonest or obviously wasteful or imprudent expenditures," wrote Justice Brandeis.¹⁶⁴ Even though the original presumption was that "[e]very investment may be assumed to have been made in the exercise of reasonable judgment . . .",¹⁶⁵ there has been a definite shift to the contrary presumption where failed nuclear projects are

157. 130 N.H. 265, 539 A.2d 263 (1988), *appeal dismissed, sub. nom.* Pub. Serv. Co. of N.H. v. N.H., 109 S. Ct. 858 (1989).

158. Radford, *The Supreme Court Took the Wrong Case*, PUB. UTIL. FORT., Feb. 16, 1989 at 4.

159. *In re Pub. Serv. Co. of N.H.*, 130 N.H. at 276, 539 A.2d at 274.

160. Radford, *supra* note 158, at 4.

161. Pub. Serv. Co. of N.H., 109 S. Ct. at 858.

162. Radford, *supra* note 158, at 4-6.

163. *Id.* at 4 (emphasis in original).

164. *Mo. ex rel. S.W. Bell Tel. Co.*, 262 U.S. at 289 n.1.

165. *Id.*

concerned.¹⁶⁶ Perhaps the Court, upon reviewing the record, determined that PSNH's nuclear investments were so obviously imprudent that no further review was necessary.

Another possible answer may perhaps be found in the state court decision in the *New Hampshire* case. The New Hampshire Supreme Court concluded that *Hope* and its progeny did not guarantee the financial integrity of public utility companies:

The Supreme Court has expressly held that it is not the mandate of the constitution to rejuvenate the value of the investments of a company whose "zenith of opportunity" has been eclipsed by the operation of economic forces. Providing a return sufficient to maintain the financial integrity of a sound company is one thing; restoring the financial integrity is another.¹⁶⁷

VI. CONCLUSION

In *Duquesne*, the Court reaffirmed the regulatory policy that it had approved forty-five years previously in *Hope*. By its acceptance of *Hope*'s end result test, the Court has declared that as long as utility rates are reasonable, in the final analysis no constitutional question has been raised. Even the mingling of apparently inconsistent rate standards is acceptable if the rates pass the end result test. The *Duquesne* decision should lay to rest the recent arguments of utilities, facing large losses on uncompleted or unneeded nuclear facilities, that the Constitution mandates a return on any prudently made investment. The decision does not, however, define the range of reasonableness in which rates can be set. As Justice Scalia noted in his concurrence, the decision deals with "techniques rather than consequences."¹⁶⁸

PETER J. GOULD

166. Laros & Haubold, *The Shifting Standard of Prudence: Implications for Utilities*, PUB. UTIL. FORT., October 29, 1987, at 21-27.

Over the years, the standard regarding the presumption of reasonableness has been gradually eroded to the point that, as a practical matter in most states, the burden of proof of demonstrating management reasonableness rests today squarely on the shoulders of the regulated utility. Nowhere has this been more evident than when utilities have sought to recover capital costs associated with the design and construction of major (primarily nuclear) power plant facilities.

Id. at 22.

167. *In re Pub. Serv. Co. of N.H.*, 130 N.H. at 272, 539 A.2d at 270 (citations omitted).

168. *Duquesne*, 109 S. Ct. at 621.