THE SUPREME COURT'S ROLE IN THE PUBLIC UTILITY RATE-MAKING PROCESS

General Telephone Co. v. Public Utilities Commission
174 Ohio St. 575, 191 N.E.2d 341 (1963)

Ohio Fuel Gas Co. v. Public Utilities Commission
174 Ohio St. 585, 191 N.E.2d 347 (1963)

The noted cases deal with two questions. First, under Ohio law what constitutes a full and sufficient allowance for the federal income tax in a rate-making proceeding? Second, how closely should the decisions of an administrative agency be reviewed by the Supreme Court?

In order to understand the problems as they arise in these cases, it is necessary to understand the procedure by which rates are made. Comprehension of this procedure is furthered by creation of a hypothetical public utility company.[1] The relevant characteristics of The Mythical Gas Co. are as follows: Mythical's debt is $45,000 and its equity is $55,000 for a total capital structure of $100,000; the interest rate on the debt is four per cent and a fair rate of return on the equity is ten per cent; the federal income tax rate is fifty per cent.[2] Finally, assume reconstruction cost new of Mythical's assets to be twice original cost or $200,000. Under Ohio law, a utility is to receive a fair rate of return on a statutory rate base.[3] In essence the rate base is determined by valuing all physical property other than land, used and useful, at reconstruction cost new[4] less depreciation.[5] Thus Mythical, which has a capital structure of $100,000, has a statutory rate base of $200,000. Noting that debt is forty-five per cent and equity is fifty-five per cent of the capital structure, it is assumed that the statutory rate base is also so divided.[6] Thus it is assumed to be composed of $90,000 debt and $110,000 equity.

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[1] For the sake of clarity this company will be referred to as The Mythical Gas Co. or simply as Mythical.

[2] For convenience, a liberty is taken with the federal tax structure.

[3] Ohio Rev. Code §§ 4909.04, 4909.05, and 4909.15 (1953).

[4] In City of Marietta v. Pub. Util. Comm'n, 148 Ohio St. 173, 74 N.E.2d 74, (1947) the syllabus, paragraph 1, reads as follows:

> The General Assembly in delegating rate-making power to the Public Utilities Commission in Ohio Gen. Code §§ 499-8, 499-9, 499-13 (1936) (now Ohio Rev. Code §§ 4909.04, 4909.05, 4901.21 (1953)), limited the Commission, in the valuation of physical utility property other than land for rate-making purposes, to the reproduction cost as of a date certain of such property as is used and useful for the convenience of the public, less observed depreciation thereon.

[5] Ohio Rev. Code § 4909.05(E) (1953).

[6] Bonbright, Principles of Public Utilities Rates 243 (1961), suggests the alternative to the Ohio procedure would be to assume a ratio which is an "ideal"

The first problem considered by the court in the instant cases is in large part the result of the unusual Ohio statute[7] which requires rates to be based on a reconstruction cost new rate base.[8] In response to this statute,[9] the court developed the "hypothetical company" concept.[10] However, a second statute[11] also requires that consideration be given to actual expenses. Under these two statutes the following procedure has been developed. The net result of the interrelationship has been the development of a complicated concept of rate-making. The instant cases point out many of the problems which develop in applying this concept; the court requires the Commission to create a hypothetical debt expense, but still requires it to use an actual allowance for income tax.

The interest that Mythical would have to pay on its debt is four per cent of $45,000, or $1,800. Thus the annual expense of debt service would be 1.8 per cent of the capital structure. In the rate-making proceeding, under Ohio law, Mythical should receive an *allowance* for debt service of 1.8 per cent of the statutory rate base or $3,600.[12] This gives an excess of $1,800 over interest *payments*. It is with this excess that the noted cases deal.

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security structure without regard to the actual capital structure of the utility. He feels the Ohio procedure is better since it does not tempt the utility to "trade on a thin equity" by overissuance of securities to enhance earnings on common stock. For a comment on this alternative procedure see General Tel. Co. v. Pub. Util. Comm'r, 174 Ohio St. 575, 582, 191 N.E. 2d 341, 345 (1963) (Herbert, J., concurring).

[7] As Rose in "Confusion in Valuation for Public Utility Rate-Making," 47 Minn. L. Rev. 1, 3-4 (1962), notes, Ohio is the only state which uses the reconstruction cost new type of rate base. As opposed to other kinds, such as the actual cost rate base, reconstruction cost new has a number of complicated conceptual problems which must be handled. For comparison, the actual cost rate base is based solely upon historical cost, and the Commission does not have to consider hypothetical interest returns and inflated rate bases.

[8] One of the lively topics in public utility regulation concerns the method by which the rate base is determined. Possible alternatives to reconstruction cost new are fair value, original cost, area rate, and prudent investment. Good discussions of this subject can be found in Bonbright, Principles of Public Utility Rates (1961) and Welch, Cases and Text on Public Utility Regulation (1961).

[9] Ohio Rev. Code § 4909.05 (1953).

[10] City of Cleveland v. Pub. Util. Comm'n, 164 Ohio St. 442, 132 N.E.2d 210 (1956).

[11] Ohio Rev. Code § 4909.15 (1953).

[12] In Ohio Fuel Gas Co. v. Pub. Util. Comm'n, 171 Ohio St. 10, 167 N.E.2d 496 (1960), the syllabus reads:

> Under Ohio statutes, in determining the rate of return to be allowed a public utility on its statutory rate base, consideration must be given to a corporation having a debt and an equity capital in a total amount substantially equal to the statutory rate base, and what is to be allowed for interest on the amount of such debt is what would be reasonably necessary to pay interest on that amount of debt even though what is so allowed for interest may be more or less than what is actually paid by such public utility on its existing indebtedness.

Now turning to the equity portion of the capital structure, the fair rate[13] of return Mythical would receive on its capital structure would be ten per cent of $55,000 or 5.5 per cent of the total capital structure.[14] Mythical should thus receive an allowance for profit of 5.5 per cent of its rate base (200,000) which would amount to $11,000. In order to protect this allowance from the federal income tax, an additional expense item[15] of $11,000 would have to be created in order to cover that tax.[16]

Looking back for a moment at our hypothetical company, Mythical is to receive 1.8 per cent of rate base for debt service and 5.5 per cent for return on equity or a total return of 7.3 per cent[17] ($14,600) on a rate base of $200,000. Consumer rates can now be set which are reasonably

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[13] In City of Portsmouth v. Pub. Util. Comm'n, 108 Ohio St. 272, 278, 140 N.E. 604, 606 (1923), per curiam, the court states that:

> It is the function of the Commission to see that the rights and obligations of both the utility and its patrons may be protected and enforced, and to deal justly between the company on one side and the public upon the other. They should look to the evidence, aided and assisted by the skilled specialists employed in their investigations, and give due heed to testimony and evidence offered by the parties, and from the entire record reach a conclusion which to the best of their judgment is a reasonable and just one to all parties concerned.

[14] 10% of $55,000 equals $5,500 or 5.5% of the capital structure of $100,000.

[15] Ohio Rev. Code § 4909.15 (1953).

[16] $22,000 will be the amount taxable at a 50% rate which will leave $11,000 as profit after tax.

[17] An explanation of the items included and excluded in this rate of return is necessary since a natural question is why worry about debt expense at this point, why not handle it like other expenses and only allot return to stockholders at this point. The rate of return by definition includes profits and excludes expenses. However, in rate-making cases one kind of expense, the debt service, is included in the rate of return. This is done to avoid a double charge to the public for interest.

If debt service were to be charged as other expenses are, after a reasonable rate of return is determined, the Commission would have to consider the debt portion of the rate base as unproductive, or abolish any distinction between equity and debt portions of the rate base and allow a uniform rate of return on the whole rate base. There would seem to be no third choice since there is no other reasonable basis by which the rate base could be divided. Considering a large portion of the rate base as unproductive is unsatisfactory, where statutes allow a reasonable rate of return. A zero return is hard to justify as a reasonable return on a large portion of the rate base. The other suggestion of a uniform rate of return on the whole rate base initially seems to offer a solution. The uniform rate of return might be lowered until the dollar return on the whole rate base approximates the return on the equity portion as currently figured. In theory this would give as satisfactory results or perhaps more satisfactory results than the current method of considering debt expense. But this proposal runs afoul of an understandable tendency in most courts to consider low rates of return to be unreasonable and confiscatory. See Kent Water & Light Co. v. Pub. Util. Comm'n, 97 Ohio St. 321, 119 N.E. 731 (1928) in which the Supreme Court held a 4½% rate of return to be unreasonable. Thus in some manner the rate is going to compensate the utility twice for the debt expense unless the present method is followed.

estimated to bring in a total gross that equals operating expenses and the dollar return on the rate base.[18]

This is the method sanctioned by the Public Utilities Commission of Ohio, and the method it used when it computed the rates involved in the instant cases. However, as the Supreme Court of Ohio realized, the return to the utility under this formula is neither 7.3 per cent nor $14,600. Refering back to the allowance for interest and the excess of $1,800 over and above interest payments noted above, it becomes obvious that for income tax purposes this sum of $1,800 cannot be deducted as an interest expense, but must be taxed as profit.[19] This produces an additional tax liability of $900.[20] Consequently, the dollar return of $14,600 is reduced to $13,700 and the rate of return is reduced from 7.3 per cent to 6.85 per cent.[21]

The Supreme Court of Ohio held this to be an unlawful reduction in the return to the utility, remanded the cases to the Commission and ordered it to make a full and sufficient allowance for federal income tax by allowing for the tax on the excess interest. The reason for the reversal is that the Supreme Court has found the hypothetical company concept to be unworkable or at least difficult to handle. The court has therefore decided to return in every case possible to an actual figure based on the utilities performance. In reversing the trend of recent cases,[22] Judge O'Neill speaks of rejecting the hypothetical company concept completely. However, the law[23] requires some retention of the concept. It will have to be used to deal with the statutory rate base. The real question was whether the concept should be extended into areas where not required by law. The court has decided it should not be.

The dynamics of rate regulation are such that by the time the Commission is ready to determine the allowance for the federal income tax, it has already determined what a fair return to the stockholders of the utility will be.[24] This was done in the Mythical Gas Co. example when the Commission decided that ten per cent of the equity portion of the capital structure would be a fair rate of return.

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[18] This is done by taking the dollar return of $14,600 and adding to it all operating expenses to reach a total dollar amount which must be provided for the year to give the profits allowed. Then the individual rates are set based on estimates of the amount of service its consumers will require during the period involved.

[19] Int. Rev. Code of 1954, § 163A.

[20] $900 is .45% of the rate base.

[21] This could be viewed in another manner which should be reported since the court considered both computations. Instead of reducing the rate of return consider the change as a reduction on the rate base. Thus $13,700 (the adjusted dollar return) is 7.3% of a rate base equal to $187,671.23.

[22] 173 Ohio St. 1, 184 N.E.2d 70 (1962); 171 Ohio St. 10, 167 N.E.2d 496 (1960); 164 Ohio St. 442, 132 N.E. 2d 416 (1956).

[23] Ohio Rev. Code §4909.04 (1953).

[24] The fair return is one of the decisions the Commission makes through use of its special expertise. Expert testimony of witnesses from the Commission staff, the utilities and the interested parties (generally cities) is taken. This testimony covers

In addition to the fair rate of return, the stockholders will also gain benefit from the other portion of the capital structure, the debt portion. As pointed out before, under Ohio law as now construed by the Supreme Court, the allowance for debt service will exceed the actual debt expense. The stockholders will benefit since this excess will fall to them. In the example, the stockholders of Mythical would receive $1,800 additional. The effect of this is to change the rate of return to stockholders from ten per cent to 11.64 per cent. As the law stood prior to this case, the allowance for income tax was sufficient only to cover the stated ten per cent return, and therefore the tax on the excess had to come from that excess. The net return to Mythical's stockholders would have been 10.82 per cent. As a result of this case, the allowance for income tax must be sufficient to cover this excess over the fair rate of return to stockholders. Mythical's stockholders will now receive the full 11.64 per cent.

Query, why should this excess be allowed at all? It is in the nature of a windfall. The Commission has already allowed the stockholders a fair return. Therefore, they are receiving more than a fair return. The Ohio law should not be construed to allow this to occur. The basic idea behind regulation of public utilities is to protect the public interest.[25] Surely, the ruling in this case does not do so. Not only does the consumer have to pay the utility more than a fair return, now the consumer must also pay the tax on that excess.

At one time, the Commission tried to allow only the actual debt expense as the return to the debt portion of the capital structure. This was rejected by the court.[26] This position was argued again in the instant case by the represented cities. No mention of this argument was made, and therefore it seems to have been rejected sub silentio.

Although the court's position is wrong as it pertains to whether the income tax expense should be increased, it should not be subjected to too much criticism for this result. As will be pointed out, the administrative process will operate to render this error de minimus. The court's more fundamental and more serious error has been in the attitude it has taken toward judicial review of the administrative process.

The Supreme Court of Ohio, in an effort to clear up the confusion surrounding the law, has become embroiled in the rate-making procedure

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such subjects as the ability of the community to pay [Re Ohio Water Service 35 P.U.R. 3d 385 (1960))], the dividend-price ratios and comparative risks of this and Comparable companies [Re Ohio Water Service 13 P.U.R. 3d 465 (1956)], the general state of the economy [Ohio Bell Tel. Co. v. Pub. Util. Comm'n, 131 Ohio St. 539, 3 N.E.2d 475 (1936)], and the rate of return necessary to induce investors to contribute capital equal to the rate base [Ohio Edison Co. v. Pub. Util. Comm'n, 173 Ohio St. 1, 184 N.E.2d 70 (1962)]. These are just examples of the many things involved. For a more comprehensive study of factors involved see Chapter 10 of Welch, Cases and Text on Public Utility Regulation (1961). After receiving testimony on all these subjects, the Commission collects all the information and comes up with a "fair rate of return."

25 Ohio Rev. Code § 4905.06 (1953).

26 Note 12, *supra*.

and seems to have lost sight of the ultimate purpose of the procedure; that is, to determine a fair rate of return for the utility while protecting the public interest, and to set rates which should reasonably give a fair return. In the instant cases, no consideration was given to whether the end result of the Commission's determination of rates was fair and reasonable; instead the court confined itself to a consideration of the formula by which the rates were to be determined.

A serious question is whether this is in the best interest of anyone concerned. To illustrate, the judicial history of the *Ohio Fuel Gas* case[27] serves as a good example. It originated in June, 1958 in an order of the Commission declaring among other things "that 'the dollar annual return to which' the gas company was 'entitled' was $104,857. . . ."[28] This order was appealed by the utility, and in 1960, on a question concerning the debt allowance, the Supreme Court reversed and ordered the Commission to reconsider the order.[29] The case came back to the court in 1963 (as part of the instant cases) and has again been remanded to the Commission, this time on a question concerning the income tax allowance. As Judge O'Neill points out, the effective dollar return allowed to the company by the Commission is $105,360.[30]

Noting that the effective dollar returns are very close after each determination, while the stated dollar returns vary from $122,873 for the first case, to $114,389 for the instant case, it is possible to speculate that in view of the history of the case the effective dollar return of the Commission's next order will be about $105,000. No matter which formula is used to make the determination, the Commission seems to be of the opinion that $105,000 is a reasonable return on the rate base. In this manner, the Commission is going to compensate for the error made by the Supreme Court.

Thus, no one really seems to be winning. The utilities and the protestant cities are spending a great deal of money on litigation. The Commission does not know which rule to follow since the rule is constantly being changed, to say nothing of the added time and expense the Commission must put in on the case as a result of the court's action. Even the Supreme Court loses in that its valuable time is taken up when that time could be devoted to other important areas. Still more time may be required of the court, if the next order of the Commission is appealed. In order to serve the general good, the Supreme Court should consider a change in its present policy of review which, as will be seen, would not require new legislation.

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[27] The case with docket number 37437 joined as part of Ohio Fuel Gas Co. v. Pub. Util. Comm'n, 174 Ohio St. 585, 191 N.E.2d 347 (1963).

[28] Ohio Fuel Gas Co. v. Pub. Util. Comm'n, *supra* note 12.

[29] In Ohio Fuel Gas Co. v. Pub. Util. Comm'n, *supra* note 12, the Commission had allowed only the actual debt expense, but the court ruled that the Commission should follow the procedure stated in the text and create a hypothetical debt expense.

[30] The annual dollar return was stated at $114,389, but because of the income tax problem discussed herein, the lower effective rate represents actual profit.

A different approach to the question of judicial review of the rate-making process has been taken by the United States Supreme Court[31] and some state courts.[32] These courts have tended to take a more limited view of their power to review an administrative order. They have been more concerned with the result reached than with the method used.[33] The United States Supreme Court has thus held:

> The Constitution does not bind rate-making bodies to the service of any single formula or combination 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.[34]

The major conflict in this area under federal law has been the composition of the rate base as dealt with in *Federal Power Comm'n v. National Gas Pipeline Co.*,[35] and *Federal Power Comm'n v. Hope Natural Gas Co.*[36] In Ohio, the composition of the rate base is determined by statute and this question is not for the discretion of the Commission. However, the federal approach to administrative discretion in the rate base determination cases is applicable to other specific subjects. The federal courts have allowed the administrative agencies to exercise discretion in the manner in which depreciation is determined[37] and in the manner in which

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31 Wisconsin v. FPC, 373 U.S. 294 (1963); FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944); FPC v. National Gas Pipeline Co., 315 U.S. 575 (1942).

32 Petition of the Mountain States Tel. and Tel. Co., 76 Idaho 474, 284 P.2d 681 (1955); Southern Bell Tel. and Tel. Co. v. Louisiana Pub. Serv. Comm'n, 272 L.A. 446, 94 So. 2d 431 (1957); New England Tel. and Tel. Co. v. State, 98 N.H. 211, 97 A.2d 213 (1953).

33 In FPC v. Hope Natural Gas Co., *supra* note 31 at 602, the court stated that:

> . . . it is not theory, but the import of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the act is at an end.

34 FPC v. Natural Gas Pipeline, *supra* note 31 at aff'd, 324 U.S. 581 (1944), 586.

35 *Supra* note 31.

36 *Supra* note 31.

37 In Colorado Interstate Gas Co. v. FPC, 142 F.2d 943, 960 (10th Cir. 1944), the court said:

> But there is no basis in this record on which it can be concluded that the determination of depreciation in the manner adopted by the commission will result in any of these orders in its entirety causing a failure to restore the capital investment at the end of the term, and therefore no deprivation of property is involved. Once more, in the absence of impingement upon due process, review is ended.

This issue was not discussed in the Supreme Court's opinion.

the implications of liberalized depreciation for rate-making purposes are handled.[38] However, that discretion is not allowed unlimited play by the courts. The decision of the agency must be reasonable and the agency must present findings of fact and reasons for the result in sufficient detail for the court to be able to determine if the action is reasonable.[39]

With the ever increasing workload on the courts and the tremendous complexity of the rate-making decision, a standard of review similar to that used by the federal courts is an appropriate answer to some of the problems facing the Ohio administrative process. This standard would meet the test laid down by the legislature which gives the Supreme Court the power to reverse the Commission when the "court is of the opinion that such order was unlawful or unreasonable"[40] and yet provide more flexibility and judicial economy than the strict review now indulged in by the Supreme Court.

In fact, the Supreme Court has professed to adopt and has paid lip service to a test much like that of the federal courts.[41] However, the court fails to apply consistently the test in such cases as the instant cases, where it does not even consider the question of reasonableness;[42] instead it concerns itself with the lawfulness of a formula used by the Commission to

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[38] In Cities of Lexington, Etc., Ky. v. FPC, 295 F.2d 109, 114 (4th Cir. 1961), the court stated that:

> We are confronted in this case with a problem in a special field which requires the expert skill that has been generally entrusted by state and federal legislation to administrative regulatory tribunals whose decisions, in the absence of abuse of discretion, should be followed by the courts. We adopt that course in this case. Insofar as liberalized depreciation is concerned the same course has been taken in El Paso Natural Gas Co. v. Federal Power Commission, 5 Cir., 281 F.2d 567, . . . and in respect to accelerated amortization . . . in City of Detroit v. Federal Power Commission . . . 230 F.2d 810, 821.

[39] In State Power Corp. Comm'n of Kansas v. FPC, 216 F.2d 690, 722 (5th Cir. 1953) the court stated that:

> We hold that the findings made as to the allowed rate of return are insufficient, and that this case must be remanded to the Commission with direction to set out more fully and particularly the facts and reasons bearing on its decision as to the rate of return. We have no desire to substitute our judgment for that of the Commission. . . . What is of importance is that we are unable from the reported findings to arrive at a reasoned conclusion that the 5½% rate of return allowed by the Commission is "just and reasonable".

[40] Ohio Rev. Code § 4903.13 (1953).

[41] In Hocking Valley Ry Co. v. Pub. Util. Comm'n, 92 Ohio St. 362, 110 N.E. 952 (1915), paragraph 1 of the syllabus reads:

> This court will not substitute its judgment for that of an administrative board, created pursuant to an act of the legislature, as to matters within its province. Before the court will interfere with an order of the railway commission or its successors, it must appear from a consideration of the record that the action of the Commission was unlawful or unreasonable.

[42] Also see Ohio Fuel Gas Co. v. Pub. Util. Comm'n, *supra* note 12; Columbus Gas & Fuel Co. v. Pub. Util. Comm'n, 129 Ohio St., 108, 193 N.E. 754 (1933); City of Cincinnati v. Pub. Util. Comm'n, 113 Ohio St. 254, 148 N.E. 817 (1925).

determine a reasonable rate when the statute[43] gives no real guide to the lawfulness of the procedure followed. Instead, the court seems to be substituting its own idea of what the Commission ought to do and how they ought to do it. The term "unlawful" ought to have a more restricted meaning in this area. Its only function is to hold the Commission within the general bounds laid down by statute. The legislature has left to the Commission a large area of discretion as to the manner in which the fair rate of return is determined. The statute only requires that:

> When the public utilities commission is of the opinion after hearing, that any rate . . . is, or will be unjust, unreasonable. . . the commission shall with due regard among other things, to the value of all property of the public utility . . . the necessity of making reservation out of the income for surplus, depreciation, and contingencies and with due regard to all such other matters as are proper, according to the facts in each case, fix and determine the just and reasonable rate.[44]

Where in this grant of power is found the key word or phrase which indicates that the Commission's method of computing the allowance for income tax was wrong in the instant cases? That word or phrase is not there, nor can it be derived from the spirit of the enactment, which is rather a spirit of administrative discretion. The court has thus deviated from a reasonable and economical standard of review of public utility rate-making to everyone's detriment and has adopted a time consuming, overly stringent standard.

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[43] Ohio Rev. Code § 4903.13 (1953).

[44] Ohio Rev. Code § 4909.15 (1953).